NO SAFE HARBOR FOR “OVERARCHING TRANSFER”: TRUSTEE CAN AVOID PAYMENTS PASSING THROUGH FINANCIAL INSTITUTIONS

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On February 27, 2018, the Supreme Court issued a significant decision that will increase the exposure of debt and equity investors that receive payments from all kinds of highly leveraged transactions, including leveraged buy-outs and dividend recapitalizations. The unanimous opinion in *Merit Management Group, LP v. FTI Consulting, Inc.* affirmed the Seventh Circuit's holding that section 546(e) of the Bankruptcy Code does not operate to shield a recipient of an alleged fraudulent transfer when the recipient is not a covered financial institution, notwithstanding the fact that the transfer at issue may have flowed through such a financial institution.[1] Overturning decisions by other circuit courts of appeal, the Court examined the statutory structure and context of the Bankruptcy Code's "safe harbor" to distinguish transfers made by, to, or for the benefit of financial intermediaries, with those that merely pass through such intermediaries.

A. FACTS

Valley View Downs, LP ("Valley View") and Bedford Downs Management Corporation ("Bedford") were competitors for the last harness-racing license in Pennsylvania.[2] Rather than continuing to fight over the license, the parties decided to join forces.[3] Specifically, they entered into an agreement whereby Bedford would withdraw its bid for the license (clearing the path for Valley View) and, after it obtained the license, Valley View would purchase Bedford.[4] Valley View would then procure additional licensing and open a "racino" — a race track with slot machines.

After Valley View obtained the license, it arranged for a loan from a syndicate of offshore banks (collectively the "Lending Bank") to finance the purchase of Bedford's outstanding stock from its shareholders.[5] The loan proceeds were transferred from Valley View's lender to a Pennsylvania bank that acted as the escrow agent for the transaction (the "Escrow Bank"). Following the closing, Valley View obtained Bedford's stock certificates and the Escrow Bank disbursed $55 million to Bedford's shareholders.[6] At the time, Merit Management Group, LP ("Merit") owned 30% of Bedford and therefore received $16.5 million in exchange for its shares.[7]

Despite winning the harness-racing license, Valley View ultimately failed to obtain additional licensing and its plans to open a racetrack casino fell through. Valley View filed for bankruptcy and FTI Consulting, Inc. was subsequently appointed to serve as the trustee of a litigation trust established under the confirmed chapter 11 plan (the "Litigation Trustee").[8]

The Litigation Trustee filed suit against Merit seeking to avoid the $16.5 million in payments from Valley View on the grounds that the payments were constructively fraudulent transfers under section 548 of the Bankruptcy Code. Section 548(a)(1)(B) allows a trustee to avoid any transfer of "an interest of the debtor in property" if debtor "received less than a reasonably equivalent value in exchange for such transfer . . . and . . . was insolvent on the date that such transfer was made . . . ."[9] The Litigation Trustee alleged that Valley View was insolvent when it purchased the Bedford shares and that Valley View "significantly overpaid" for the stock.[10]

B. THE DISTRICT COURT DECISION AND SECTION 546(E) "SAFE HARBOR"

At the district court, Merit argued that under section 546(e) of the Bankruptcy Code the payments it received from the sale of Bedford stock were insulated from attack.[11] Specifically, section 546(e) prevents a trustee from avoiding a constructive fraudulent transfer that constitutes (1) "a 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 (2) "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 . . . ."[12] Because Merit received its cash consideration for the sale of Bedford stock from the Escrow Bank, Merit argued that it was immune from suit under the "safe harbor" created by section 546.

The parties did not dispute that Merit had received a "settlement payment" or that the banks that participated in the stock purchase were "financial institutions."[13] The case, therefore, turned on whether the "transfer" which the Litigation Trustee sought to avoid had been made "by or to (or for the benefit of) . . . a financial institution."[14] After an exhaustive survey of existing case law on the issue, the district court concluded that a plain reading of section 546(e) applied to shield the recipients of otherwise avoidable settlement payments when one or more financial institutions serve as intermediaries between the debtor and the ultimate transferee.[15]

C. THE SEVENTH CIRCUIT DECISION

On appeal from the district court, the Seventh Circuit framed the question as "whether the section 546(e) safe harbor protects transfers that are simply conducted through financial institutions (or the other entities named in section 546(e)), where the entity is neither the debtor nor the transferee but only the conduit."[16] The Seventh Circuit found the phrases "by or to" and "for the benefit of" ambiguous as they appear in section 546(e) because it was unclear whether these phrases were intended to include or ignore intermediaries participating in a transfer between the debtor and the transferee.[17] Turning to the statute's purpose and historical context for guidance, the Seventh Circuit noted that the avoidance powers set forth in chapter 5 of the Bankruptcy Code and the safe harbor in section 546 are "two sides of the same coin."[18] Merit's position would throw the avoidance powers and safe harbor out of balance by "render[ing] any transfer non-avoidable unless it were done in cold hard cash . . . ."[19] Observing that the purpose of section 546 is to protect the network of financial intermediaries that form the country's payment systems and to prevent "one large bankruptcy from rippling through the securities industry," the Seventh Circuit reversed the district court, holding that Merit could not seek refuge in a safe harbor not designed for private transactions like the one between Valley View and the Bedford shareholders.[20]

D. ANALYSIS

The Supreme Court affirmed the Seventh Circuit, although the Court was not concerned by any alleged ambiguities in the statute. Writing for a unanimous Court, Justice Sonya Sotomayor opined that once the challenged transfer is brought into focus, it was obvious that Merit was not covered by the safe harbor. The transfer in this case involved four entities (A) Valley View; (B) the Lending Bank; (C) the Escrow Bank; and (D) Merit. The real question was whether section 546(e) requires the reviewing court to consider all the "component parts" of the transaction or just the "overarching transfer" that the trustee seeks to avoid.[21] Based on the context and structure of the statute, the Court concluded that the overarching transfer is the relevant item to be analyzed.

In its analysis, the Court began with the text of section 546(e). The first clause reads, "[n]otwithstanding sections 544, 545, 547, 548(a)(1)(b), and 548(b) of this title . . .," indicating that section 546 is tied to the transfers that the trustee is seeking to avoid under the other provisions of chapter 5.[22] By referencing specific types of transfers, Justice Sotomayor explained, Congress has signaled that the safe harbor applies to the overarching transfer, and not any component part of that transfer.[23] In order to come within the safe harbor, it is not sufficient for the transfer to "involve" or "comprise[]" elements of section 546. Rather, the entire transaction must be of the kind described in section 546.[24]

The Court then turned to the statutory structure to reinforce its reading. Agreeing with the Seventh Circuit that the avoidance powers and safe harbor were two sides of the same coin, the Court concluded that "it is only logical to view the pertinent transfer under § 546(e) as the same transfer that the trustee seeks to avoid pursuant to one of its avoiding powers."[25] In other words, transfers protected by the safe harbor must mirror the kinds of transfers that the trustee could otherwise avoid. In this case, for example, the Litigation Trustee was not seeking to avoid (nor could he have) the transfer of funds between the Lending Bank and the Escrow Bank. Emphasizing the banks' role distorts the nature of the transaction and is irrelevant to the analysis.[26]

Merit argued that the disjunctive phrase "by or to (or for the benefit of)" allowed a transfer to come within section 546(e) even if the financial intermediary lacks a beneficial interest in the property transferred. The Court rejected this argument finding nothing in the text or legislative history to support Merit's position. The simpler explanation was that the phrase "for the benefit of" appears through chapter 5 of the Bankruptcy Code when discussing the types of indirect transfers that a trustee may avoid and was added to section 546(e) to bring it into harmony with the avoidance powers.[27] Merit further argued that one of the identified entities, a "securities clearing agency," could only ever act as an intermediary necessitating a broader reading of section 546(e). The Court refused to accept this premise, and reiterated that if the transfer the trustee seeks to avoid was made by or to a securities clearing agency, the safe harbor will apply.[28] The problem for Merit, of course, is that the Litigation Trustee had not sought to avoid such a transfer. Finally, the Court rejected Merit's contention that Congress had intended to take a prophylactic approach to protecting the interests of all market participants and in promoting finality in securities transactions. Justice Sotomayor found that this reading was not supported by the text of section 546(e).[29] Accordingly, the Court affirmed the Seventh Circuit's decision.

E. CONCLUSION

The Supreme Court's decision in *Merit Management* clarifies that the section 546(e) safe harbor only applies to a transfer by or to or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency. If any of those entities serve as mere conduits in the overarching transfer that the trustee seeks to avoid, the safe harbor will not apply to protect the ultimate transferee. The decision will likely be viewed as a boon to bankruptcy trustees and creditors' committees that seek to unwind leveraged buyouts, dividend recapitalizations, and other highly leveraged transactions involving the purchase or redemption of securities. Whether, absent financial intermediaries, parties to a highly leveraged transaction qualify under the safe harbor of section 546 remains to be seen.

Notes:

[1] *See* No. 16-784, 583 U.S. __ (2018), slip op. at 1 (the "SCOTUS Decision")
[2] *See id*. at 6-7.
[3] *See FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690, 691 (7th Cir. 2016) *aff'd* 583 U.S. __ 2018) (the "Seventh Circuit Decision").
[4] *See SCOTUS Decision* at 7-8.
[5] *See Seventh Circuit Decision* at 691.
[6] *See SCOTUS Decision* at 7-8.
[7] *See Seventh Circuit Decision* at 692.
[8] *See SCOTUS Decision* at 8.
[9] *See* 11 U.S.C. § 548(a)(1)(B)(i) and (ii) (I).
[10] *See SCOTUS Decision* at 8.
[11] *See FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*., 541 B.R. 850, 852 (N.D. Ill. 2015), *rev'd sub nom. FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 830 F.3d 690 (7th Cir. 2016), *aff'd and remanded*, (U.S. Feb. 27, 2018) (the "District Court Opinion").
[12] *See* 11 U.S.C. § 546(e).
[13] *See District Court Opinion* at 854.
[14] *See District Court Opinion* at 854.
[15] *See id*. at 859 ("[A] transfer that is 'by or to' a financial institution is just that: a transfer where a financial institution sends or receives funds.").
[16] *See Seventh Circuit Decision* at 691.
[17] *See id.* at 692-93 (explaining that a postcard sent through the U.S. Postal Service could be said to have been sent "by" the Postal Service or "by" the sender who filled it out and the phrase "for the benefit of" could either refer to a transaction made *on behalf* of another entity, or it could mean a transaction merely *involving* an entity receiving an actual financial or beneficial interest).
[18] *See id*. at 694.
[19] *See id*. at 695.
[20] *See id*. at 696 (quoting Grede v. FCStone, LLC, 746 F.3d 244, 252 (7th Cir. 2014).
[21] *See id.*
[22] *See id.* at 11.
[23] *See id*. at 12.
[24] *See id*. at 13.
[25] *See id.*
[26] *See id*. at 14 ("If a trustee properly identifies an avoidable transfer, however, the court has no reason to examine the relevance of component parts when considering a limit to the avoiding power, where that limit is

defined by reference to an otherwise avoidable transfer, as is the case with § 546(e) [].").
[27] *See id.* at 15.
[28] *See id*. at 17.
[29] *See id*. at 18.

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