Creditors' Rights and Bankruptcy Practice Group

GOODSILL ALERT

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SUPREME COURT NARROWS SECTION 546(E) SAFE HARBOR REGARDING TRANSFERS INVOLVING FINANCIAL INSTITUTIONS

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In the case of *Merit Management Group, LP v. FTI Consulting, Inc., 16-784 (February 27, 2018)*, the U.S. Supreme Court held that the safe harbor contained in section 546(e) of the Bankruptcy Code is not triggered when a financial institution is acting as an intermediary in a securities transaction.

BACKGROUND FACTS

The Bankruptcy Code allows trustees to set aside and recover transfers "of an interest of the debtor in property" for the benefit of the bankruptcy estate, including certain transfers that are either intentionally or constructively fraudulent. 11 U. S. C. §548(a). The Bankruptcy Code also contains a number of exceptions to this avoiding power, which limit a trustee's ability to recover certain types of transfers made to certain types of entities.

Section 546(e) of the Bankruptcy Code is one of those exceptions and provides that a trustee may not avoid a "settlement payment" or transfer that is "made by or to (or for the benefit of) a … financial institution" in connection with a "securities contract," unless the transfer was made with actual intent to hinder, delay, or defraud creditors under 548(a)(1)(A). 11 U. S. C. §548(e).

This case concerned an agreement between Valley View Downs, LP ("Valley View") and Bedford Downs Management Corporation ("Bedford Downs") to resolve a dispute over a harness-racing license wherein, among other things, Valley View was to purchase all of Bedford Downs' stock for the sum of $55 million. Id. at 7.

Valley View arranged for the Cayman Islands branch of Credit Suisse to finance the $55 million purchase price by wiring the money to Citizens Bank of Pennsylvania, which had agreed to serve as the third-party escrow agent for the transaction. Id.

As part of the transaction, each of Bedford Downs' shareholders, including Merit Management Group, LP ("Merit"), deposited their stock certificates into escrow. Id. When the transaction was completed, Merit received approximately $16.5 million from the sale of its Bedford Downs stock to Valley View. Id. at 8.

Valley View and its parent company, Centaur, LLC, later filed for Chapter 11 bankruptcy protection. Id. In that proceeding, the Bankruptcy Court confirmed a chapter 11 plan and appointed FTI Consulting, Inc. ("FTI"), to serve as trustee of the Centaur litigation trust. Id.

FTI filed a lawsuit against Merit seeking to avoid the $16.5 million transfer from Valley View to Merit for the sale of Bedford Downs' stock as constructively fraudulent under §548(a)(1)(B) of the Bankruptcy Code, alleging that Valley View was insolvent when it purchased Bedford Downs and "significantly overpaid" for the Bedford Downs stock. Id.

In the lawsuit, Merit moved for judgment on the pleadings under Federal Rule of Civil Procedure 12(c), contending that the Section 546(e) safe harbor barred FTI from avoiding the Valley View-to-Merit transfer. Id. Specifically, Merit argued that the safe harbor applied because the transfer was a "settlement payment . . . made by or to (or for the benefit of)" a covered "financial institution"—here, Credit Suisse and Citizens Bank. Id. at 8-9.

The District Court granted Merit's Rule 12(c) motion, reasoning that the §546(e) safe harbor applied because the financial institutions transferred or received funds in connection with a "settlement payment" or "securities contract." Id. at 9. The 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. Id.

The U.S. Supreme Court granted certiorari to resolve a conflict among the circuits as to the proper application of the §546(e) safe harbor. Id.

THE SUPREME COURT'S DECISION

Before the Supreme Court, Merit argued that the Court should look not only to the Valley View-to-Merit end-to-end transfer, but also to all of its component parts, including the $16.5 million transfer by Credit Suisse to Citizens Bank and two transactions by Citizens Bank to Merit (i.e., the transmission of $16.5 million over two installments by Citizens Bank as escrow agent to Merit). Id. at 10. Because the component parts included transactions by and to "financial institutions," Merit contended that Section 546(e) barred avoidance of the transfer. Id.

On the other hand, FTI argued that the only relevant transfer for purposes of the §546(e) safe harbor inquiry was the overarching transfer between Valley View and Merit of $16.5 million for purchase of the stock, which is the transfer that the trustee sought to avoid under §548(a)(1)(B). Id. FTI argued that because that transfer from Valley View to Merit was not made by, to, or for the benefit of a financial institution, the safe harbor has no application. Id.

The Supreme Court agreed with FTI. Id. The Court explained that "to qualify for protection under the securities safe harbor, §546(e) provides that the otherwise avoidable transfer itself be a transfer that meets the safe-harbor criteria." Id. at 13. The Court explained:

> The safe harbor saves from avoidance certain securities transactions 'made by or to (or for the benefit of)' covered entities. Transfers 'through' a covered entity, conversely, appear nowhere in the statute.

Id. at 18.

The Court explained that the relevant transfer for purposes of the §546(e) safe harbor analysis is the transfer that the trustee seeks to avoid pursuant to its substantive avoiding powers, i.e. the end-to-end transfer of $55 million from Valley View to Merit. Id.

The Court concluded that "[b]ecause the parties do not contend that either Valley View or Merit is a "financial institution" or other covered entity, the transfer falls outside of the §546(e) safe harbor. " Id. at 19.

CONCLUSION

The U.S. Supreme Court's unanimous ruling in *Merit Management Group LP v. FTI Consulting Inc.*, resolves a long-standing circuit split over the scope of section 546(e)'s "safe harbor" provision exempting certain securities transaction payments from avoidance as fraudulent transfers. It is now clear that the Bankruptcy Code does not protect transfers simply because they are made through a financial institution because the relevant inquiry is whether the transferor or transferee are financial institutions themselves.

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