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SCOTUS: No Safe Harbor Protection Where Financial Institutions Are Mere Intermediaries

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On Feb 27, 2018, in *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018) (http://bit.ly/2u8vFYv), the Supreme Court of the United States issued a decision holding that: 1) the only relevant transfer for purposes of analyzing whether the Bankruptcy Code section 546(e) "safe harbor" applies is the "overarching transfer" that the trustee is seeking to avoid (as opposed to the component transfers between mere intermediaries); and 2) under the facts presented, the relevant transfer between the debtor and transferee was not covered by the safe harbor because it was not "made by or to (or for the benefit of)" a "financial institution" or other covered entity. *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018), *abrogating In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013), *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009), *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009), *In re Resorts Int'l Inc.*, 181 F.3d 505 (3d Cir. 1999), *In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991).

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The Court's decision is instructive and likely welcomed by trustees and other estate fiduciaries faced with transferees asserting safe harbor defenses where financial institutions are involved (or other covered entities) are mere intermediaries (*i.e.*, did not receive a financial benefit). But, as discussed below, it is unclear whether the Court resolved all debates concerning section 546(e) safe harbor's application. Regardless, the Court's decision and analysis are instructive for both bankruptcy and corporate practitioners, and will likely yield significant returns for estate beneficiaries.

Background

In 2003 Valley View Downs, LP and Bedford Downs Management Corporation were competing for the last harness-racing license in Pennsylvania. *Merit Management Group* at 890. Valley View and Bedford Downs entered into an agreement pursuant to which Bedford Downs would abandon its fight for the license. *Id.* at 891. Valley View obtained the license, and purchased Bedford Downs' stock for $55 million as part of a larger transaction. *Id.* Credit Suisse wired $55 million to Citizens Bank of Pennsylvania, the third-party escrow agent for the transaction, and Bedford Downs' shareholders placed their stock certificates in escrow. *Id.* Between 2007 and 2010, Valley View purchased all of Bedford Downs' stock for $55 million after Valley View obtained the certificates, and Citizens Bank disbursed the funds. *Id.* Merit Management, one of Bedford Downs' selling shareholders, received approximately $16.5 million. *Id.* Thereafter, Valley View failed to obtain a separate gaming license, and together with its parent company (Centaur, LLC) eventually filed voluntary chapter 11 petitions. *Id.* A plan of reorganization was confirmed, and FTI Consulting, Inc. was appointed trustee of a litigation trust. *Id.*

Procedure

FTI, as trustee, commenced an adversary proceeding in the Northern District of Illinois against Merit Management seeking to avoid the $16.5 million "transfer" (note this is singular) as constructively fraudulent under Bankruptcy Code section 548(a)(1)(B) (among other Bankruptcy Code sections). *Merit Management Group* at 891. Merit Management moved for judgment on the pleadings arguing that the section 546(e) "safe harbor" prevented FTI from avoiding the transfer. Id. Merit focused on the transfer between Credit Suisse and Citizens Bank, and argued that it was protected as a "settlement payment … made by or to (or for the benefit of) … a financial institution." *Id.* The District Court held that the 546(e) safe harbor applied, because the funds were "transferred or received … in connection with a 'settlement payment' or 'securities contract.'" *FTI Consulting, Inc. Trustee of the Centaur, LLC Litigation Trust v. Merit Management Group, LP*, 541 B.R. 850, 858 (N.D. Ill. 2015) (holding payments made by the debtor in exchange for shares in an entity, and that entity's transfer of a percentage of those proceeds to one of its shareholders, were protected by the safe harbor even though the covered entities involved were mere

intermediaries or conduits). The Court of Appeals for the Seventh Circuit reversed and held that 546(e) does not protect transfers in which "financial institutions" serve as "mere conduits." *FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690, 691 (7th Cir. 2016)).

The Supreme Court granted *certiorari* "to resolve a conflict among the circuit courts as to the proper application of the 546(e) safe harbor," and for the reasons discussed in the opinion and below, affirmed the Seventh Circuit's decision.

Decision Affirming The Seventh Circuit

By granting *certiorari*, the Supreme Court intended to resolve the conflict among the circuit courts as to whether 546(e) will protect an otherwise avoidable transfer when a "financial institution" serves as an intermediary or mere conduit, and is not truly a party to the transaction at issue.

The Plain Meaning

The Supreme Court states that its decision is based on the "plain meaning" of section 546(e), whereas the Seventh Circuit stated in its decision that "[t]he language of the statute, standing alone, does not point us in one direction or the other." 830 F.3d 690, 693 (7th Cir. 2016). This apparent inconsistency is resolved by the Supreme Court's decision stating that the lower courts "put the proverbial cart before the horse" by looking first to the language "by or to (or for the benefit of)" and whether the "financial institution" must have a beneficial interest in the property transferred in order for the safe harbor to apply. 138 S. Ct. 883, 892. Instead, the Supreme Court instructs, courts must analyze the issues in two parts, in this order: 1) which transfer is the relevant transfer; and 2) whether that transfer in particular is covered by the safe harbor.

The Relevant Transfer Is The Transfer the Trustee Seeks to Avoid

The Supreme Court relies on the plain meaning of the statute and adopts FTI's argument that the relevant transfer for purposes of a 546(e) analysis is the transfer the trustee seeks to avoid (as opposed to component transfers between intermediaries, even where those intermediaries are covered entities). *Id*. The Court cites to the language of 546(e), the "specific context," and the "broader statutory structure", and rejects Merit's arguments relying upon the 2006 amendment to the statutory text of 546(e) (adding "(or for the benefit of)"), the inclusion of "securities clearing agencies" as covered entities (they are expressly defined as "intermediaries"), and Congress' alleged purpose in enacting the safe harbor (to protect securities and commodities transactions, and not focus on the identity of the investors or their investments). 138 S. Ct. 883, 895-97.

546(e) Does Not Apply If Neither Party Is a Covered Entity

Merit had relied, in part, on the fact that a financial institution (i.e, a covered entity) was a party to one of the intermediate transactions. Because neither party argued that Valley View (the initial transferor) or Merit (the ultimate transferee) was a "financial institution" or other covered entity, the Supreme Court held that 546(e) did not apply to protect the relevant transfer that FTI sought to avoid — the transfer from Valley View to Merit (not the intermediate transfers between Credit Suisse and Citizens Bank). 138 S. Ct. 883, 897.

Conclusion: Practitioners Pointers

The Supreme Court's decision is likely welcomed by trustees because it seemingly prevents transferees from asserting the 546(e) safe harbor where the only covered entity is an intermediary which did not receive a financial benefit. As a result of the Court's decision, practitioners should expect to see stalled avoidance actions move forward, or settle with larger returns for estates than if the Court had held in favor of Merit.

There are issues and questions parties should consider when confronting (or attempting to assert) the 546(e) safe harbor in light of the Supreme Court's decision.

1. Actual fraudulent transfers under Bankruptcy Code section 548(a)(1)(A) are not protected by the safe harbor.
2. Whether it makes sense to seek to avoid component transfers in a transaction, or an "overarching transfer" by or for the benefit of a debtor.
3. Whether the "financial institution" or other covered entity involved in a transaction outside of bankruptcy could or should receive some type of financial benefit; and whether that financial benefit provided for that sole purpose would be sufficient to fall under the 546(e) safe harbor in the event of a future bankruptcy filing. The Supreme Court did not state that a financial institution or other covered entity must receive a benefit in order for a transaction to be covered under 546(e), although the Supreme Court does state that "[t]ransfers 'through' a covered entity, … appear nowhere in the statute." 138 S. Ct. 883, 896.

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