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Spotlight On The Section 546(e) Rift

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On Sept. 10, 2015, in light of new evidence presented, the United States Bankruptcy Court for the Northern District of Illinois entered an order vacating its April 24, 2015, ruling in Krol v. Key Bank National Association (In re MCK Millennium Centre Parking LLC), which held that certain payments on securitized loans were protected by the safe harbor provision of Bankruptcy Code Section 546(e). (Case No. 14-00392 (Bankr. N.D. Ill. Sept. 10, 2015)).

The court had ruled that repayments made by the debtor to a commercial bank on a loan, where the promissory note evidencing the loan was held by a commercial mortgage-backed security real estate mortgage conduit trust, were protected by the safe harbor provisions of Bankruptcy Code Section 546(e) and, therefore, not avoidable, because they were made to a "financial institution," "in connection with" a "securities contract." See In re MCK Millennium Centre Parking, 14-00392, (Bankr. N.D. Ill. April 24, 2015). Notably, the court "decline[d] to read into the statute the additional requirement that the financial institution receive some financial benefit or acquire the funds for its own use."

The court's recent decision vacating its prior order is based on new evidence obtained from the defendants indicating that the actual master servicer of the loan and, therefore, recipient of the transferred funds, was not Key Bank National Association, a commercial bank which is clearly a "financial institution," but rather KeyCorp Real Estate Capital Markets Inc., an affiliate of Key Bank which, according to the court, is not a financial institution. Based upon this new evidence, the plaintiff, the Chapter 7 trustee, may file a second amended complaint. The Sept. 10, 2015, decision makes no mention of whether it will re-examine the issue of whether a "financial institution" must receive the funds for its own benefit, or acquire some interest in the funds transferred.

The court's recent order highlights a split in the circuits over whether Bankruptcy Code Section 546(e) should be applied to protect a transfer made by and to a "financial institution," even where that "financial institution" gains nothing financially from the transfer, and did not acquire the funds for its own use. See, e.g., FTI Consulting Inc., Trustee of the Centaur LLC Litigation Trust v. Merit Management Group LP, No. 11 C 7670, (N.D. Ill. Oct. 2, 2015) (discussing split in circuits over issue of interpretation and application of the phrase "by or to (or for the benefit of) ... a financial institution" and holding that transfers made to a "financial institution" as escrow agent, in connection with a settlement agreement to purchase stock, are not avoidable as a result of Section 546(e)).

The majority position, adopted by the Second, Third, Sixth, Eighth and Tenth Circuits, is that transfers made “to or for the benefit of” a “financial institution” “in connection with a securities contract” are protected by Section 546(e), even if the “financial institution” gained no financial benefit, because the plain language of the statute does not contain language requiring that it receive a financial benefit upon receipt of the funds. See, e.g., In re Quebecor World (USA) Inc., 719 F.3d 94, 99-100 (2d Cir. 2013) (holding financial intermediary need not have a beneficial interest in a transfer to be protected by Section 546(e)); In re Plassein International Corp., 590 F.3d 252, 257 (3d Cir. 2009); In re QSI Holdings Inc., 571 F.3d 545, 550 (6th Cir. 2009); Contemporary Industries Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009); In re Kaiser Steel Corp., 952 F.2d 1230 (10th Cir. 1991).

The Seventh Circuit has not yet ruled on this issue, but presumably would follow the “plain meaning” approach. See FTI Consulting Inc., Trustee of the Centaur LLC Litigation Trust v. Merit Management Group LP, No. 11 C 7670, (N.D. Ill. Oct. 2, 2015) (noting the Seventh Circuit follows the plain language of the statute not because it adheres only to the text, but because of the potential catastrophic consequences in the securities markets of not allowing those parties to know they have a final and completed transaction) (citing Peterson v. Somers Dublin Ltd., 729 F.3d 741, 748 (7th Cir. 2013); Grede v. FCStone LLC, 746 F.3d 244, 252 (7th Cir. 2014)).

The minority position adopted only by the Eleventh Circuit requires a financial institution to have acquired a beneficial interest in the transferred funds for the safe harbor to apply. See, e.g., Mumford v. Valuation Research Corp. (In re Mumford Inc.), 98 F.3d 604, 610 (11th Cir. 1996) (holding Bankruptcy Code Section 546(e) will not protect transfers where the financial institution is an “intermediary or conduit”). In FTI Consulting Inc., Trustee of the Centaur LLC Litigation Trust v. Merit Management Group LP, No. 11 C 7670, (N.D. Ill. Oct. 2, 2015), the liquidating trustee unsuccessfully argued for the court to adopt the minority approach because “the legislative history shows that the safe harbor does not protect a financial institution unless unraveling the transaction would expose the securities market to systemic risk.” FTI Consulting Inc., Trustee of the Centaur LLC Litigation Trust v. Merit Management Group LP, No. 11 C 7670, (N.D. Ill. Oct. 2, 2015) (discussing split in circuits over issue of interpretation and application of the phrase “by or to (or for the benefit of) ... a financial institution” and holding that the transfer was entitled to 546(e) protection even though financial institutions had no beneficial interest in the transferred funds).

The court also raised an interesting question as to whether the court in In re Mumford might have reached a different conclusion if the financial institution at issue was a commercial bank that obtained a financial benefit through a float (i.e., money in the banking system that can be used by banks as an asset between a deposit being made in the payee’s account and the money deducted from the payor’s account). Id.

The majority’s “plain meaning” approach to 546(e) provides the financial markets with some sense of stability and finality, without which certain financial institutions might be unwilling to conduct business in the marketplace. That said, it also appears to offer a free pass from trustees’ avoidance actions as long as “settlement payments” made “in connection with a securities contract” are first transferred to a “financial institution,” if even for a moment. In contrast, the minority approach relies on legislative history to read a requirement into the statute that the “financial institutions” must also obtain some financial benefit.

It remains to be seen whether the bankruptcy court in In re MCK Millennium will, upon considering a second amended complaint from the Chapter 7 trustee, also revisit the issue as to whether a transfer to

a “financial institution” may be afforded the protections of 546(e) if it acted as a mere conduit or intermediary.

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