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Seventh Circuit Takes the Road Less Traveled, and Looks to the Substance of § 546(e)

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In a surprise decision, the U.S. Court of Appeals for the Seventh Circuit declined to follow the "plain meaning" approach adopted by the Second, Third, Sixth, Eight and Tenth Circuits, and rejected an opportunity to expand the safe-harbor protections afforded by Bankruptcy Code section 546(e) to protect "securities transactions" in the private market where the extent of a financial institution's involvement is to serve as an intermediary or conduit. *FTI Consulting, Inc. v. Merit Management Group, LP*, No. 15-3388, 2016 WL 4036408 *6 (7th Cir. July 28, 2016) ("We will not interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds.").

Background

On July 18, 2016, the Seventh Circuit reversed and remanded a decision by the United States District Court for the Northern District of Illinois, which held that "settlement payments" made "in connection with a securities transaction" through a "financial institution" were protected by the safe harbor provisions of Bankruptcy Code section 546(e) based upon the "plain meaning" of the statute. *FTI Consulting, Inc., Trustee of the Centaur, LLC Litigation Trust v. Merit Management Group, LP*, 541 B.R. 850 (N.D. Ill. 2015) (holding payments made by the debtor in exchange for the shares of another entity, and that entity's transfer of a percentage of the proceeds to one of its shareholders, were protected by Bankruptcy Code section 546(e)'s safe harbor even though the funds merely passed through Citizens Bank and Credit Suisse, as intermediaries or conduits).

'Financial Institutions' Under 546(e)

This is the Seventh Circuit's first decision squarely on the issue of whether transfers made "to or for the benefit of" a "financial institution" (which are otherwise "settlement payments" made "in connection with a securities contract") are protected from avoidance

by 546(e), even if the transfers were not between parties named by section 546(e) and the financial institution obtained no benefit from the transaction.

Seventh Circuit Adopts the Minority Position

Notably, the Seventh Circuit strayed from the majority of its sister courts in holding that the transfers were not protected from avoidance merely because the funds passed through a "financial institution" which served only as a conduit and received no financial benefit. *FTI Consulting, Inc. v. Merit Management Group, LP*, No. 15-3388, 2016 WL 4036408 *6 (7th Cir. July 28, 2016) ("We recognize that we are taking a different position from the one adopted by five of our sister circuits, which have interpreted 546(e) to include the conduit situation.") (citing *In re Quebecor World (US) Inc.*, 719 F.3d 94 (2d Cir. 2013) (holding that a financial intermediary need not have a beneficial interest in a transfer to be protected by 546(e)); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 505, 516 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 (10th Cir. 1991)).

The U.S. Court of Appeals for the Eleventh Circuit issued the only other circuit court decision in agreement with the Seventh Circuit. *See Matter of Munford, Inc.* , 98 F.3d 604, 610 (11th Cir. 1996) (holding payments from debtor to shareholders not prtected by section 546(e) because financial institutions received no financial benefit).

The Seventh Circuit rejected the argument that the 2006 Amendment to section 546(e) adding "(or for the benefit of)" (*see* H.R. Rep. 109-648, at 23, reprinted in 2006 U.S.C.C.A.N. 1585, 1593) was a response to the Eleventh Circuit's decision. *FTI Consulting, Inc. v. Merit Management Group, LP*, No. 15-3388, 2016 WL 4036408 *6 (7th Cir. July 28, 2016) ("If Congress had wanted to say that acting as a conduit for a transaction between non-named entities is enough to qualify for the safe harbor, it would have been easy to do that. But it did not.").

Seventh Circuit Looks Beyond the 'Plain Meaning' of 546(e)

Prior decisions by the Seventh Circuit interpreted other aspects of section 546(e) broadly and pursuant to the "plain language" of the statute. *See, e.g., Grede v. FCStone LLC*, 746 F.3d 244, 252 (7th Cir. 2014) (holding prepetition transfer by debtor, an investment management firm, to customer commodity broker was protected by

546(e) safe harbor as "settlement payments" made "in connection with a securities contract" and stating "[w]e do not see any reason to depart from the deliberately broad text of section 546(e)"); *Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 748 (7th Cir. 2013) (holding debtors' prepetition redemption payments to investors were protected by safe harbor of section 546(e) as "settlement payments" made "in connection with a securities contract" and stating that "[t]he text is what it is and must be applied whether or not the result seems equitable") (citing *Freeman v. Quicken Loans, Inc.*, 132 S.Ct. 2034 (2012)).

In this case, the Seventh Circuit referred to the statutory language as ambiguous, and looked to the context of 546(e) in Chapter 5 of the Bankruptcy Code, and the history behind the safe harbor protection. *FTI Consulting, Inc. v. Merit Management Group, LP*, No. 15-3388, 2016 WL 4036408 *3 (7th Cir. July 28, 2016) ("The language of the statute, standing alone, does not point us in one direction or the other.").

With respect to the context of 546(e), the Seventh Circuit agreed with plaintiff FTI's argument that the safe harbor should apply "to transfers that are eligible for avoidance in the first place." *FTI Consulting, Inc. v. Merit Management Group, LP* No. 15-3388, 2016 WL 4036408 *3 (7th Cir. July 28, 2016) (stating "logically these are two sides of the same coin").

The court also agreed with the plaintiff's argument that like Bankruptcy Code section 548(d)(2), which protects certain named entities from fraudulent transfer actions under 548(c), section 546(e)'s safe harbor should only be applicable to one of the named entities. *Id*. (rejecting the defendant's argument that 548(c) is distinguishable because it is "transferee-specific" and 546(e) addresses the transfer, not the transferee).

Financial Institutions Must 'Exercise Dominion or Control' over Funds to Be Protected

The Seventh Circuit relied upon and extended reasoning from an earlier decision holding that in a "transferee" must exercise "'dominion or control over the money or 'the right to put the money to one's own purposes'" *Bonded Financial Services, Inc. v. European American Bank*, 838 F2d 890, 893 (7th Cir. 1988), and held that "transfers 'made by or to (or for the benefit of)' in the context of 546(e) refer to transfers made to 'transferees' as defined there.'" *FTI Consulting, Inc.*

v. Merit Management Group, LP, No. 15-3388, 2016 WL 4036408 *5 (7th Cir. July 28, 2016). In other words, a transfer to a financial institution cannot be protected under 546(e) unless that financial institute satisfies the definition of "transferee" and acts as more than a simple conduit.

Effect on the Marketplace

Likely anticipating an uproar from both those in the financial services industry claiming that its decision will wreak havoc on the marketplace, and those in the legal field claiming that its decision does not comport with prior decisions that section 546(e) should be interpreted broadly and encourage stability in the marketplace, the Seventh Circuit relied upon the history of section 546(e) to "illustrate[] why [its] holding will not give rise to problems in the financial-services markets" and explain that even a broad interpretation has "limits." *FTI Consulting, Inc. v. Merit Management Group, LP*, No. 15-3388, 2016 WL 4036408 *5 (7th Cir. July 28, 2016) (citing *Grede v. FCStone, LLC*, 746 F.3d at 254 ("Those dealing in securities have an interest in knowing that a deal, once completed, is indeed final so that they need not routinely hold reserves to cover the possibility of unwinding the deal if a counter-party files for bankruptcy in the next 90 days.").

The Seventh Circuit noted that "the safe harbor's purpose is to 'protect the market from systemic risk and allow[] parties in the securities industry to enter into transactions with greater confidence' — to prevent "'one large bankruptcy from rippling through the securities industry.'" *Id*. (quoting *Grede v. FCStone, LLC* , 746 F.3d 244, 252 (7th Cir. 2014))

In this case, the Seventh Circuit was "not troubled by any potential ripple effect through the financial markets" from allowing avoidance of the transaction and recovery of the funds, however, because the transaction at issue involved two private corporations exchanging money for privately held stock. *FTI Consulting, Inc. v. Merit Management Group, LP*, No. 15-3388, 2016 WL 4036408 *6 (7th Cir. July 28, 2016) ("[The debtor's] bankruptcy will not trigger bankruptcies of any commodity or securities firms. Even if [the debtor's bankruptcy] were to 'spread' to [the defendant] after avoidance of the transfer, there is no evidence that it would have any impact on Credit Suisse, Citizens Bank, or any other bank or entity named in section 546(e).").

Conclusion

It appears that in the Seventh and Eleventh Circuits, a private party attempting to benefit from the safe harbor protections of Bankruptcy Code section 546(e) will need to do more than point to the plain language of the statute, warn of catastrophic consequences of undoing a transaction tangentially related to the securities market, and point to the fact that funds went through a financial institution at some point in the transaction.

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