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SUPREME COURT SETTLES CIRCUIT SPLIT CONCERNING BANKRUPTCY CODE "SAFE HARBOR"

To Our Clients and Friends:

On February 27, 2018, the U.S. Supreme Court issued a decision in *Merit Management Group, LP v. FTI Consulting, Inc.* (No. 16-784), settling a circuit split regarding the "safe harbor" provision in § 546(e) of the Bankruptcy Code. That section bars the avoidance of certain types of securities and commodities transactions that are made by, to or for the benefit of covered entities including financial institutions, stockbrokers and securities clearing agencies.

Circuits had split regarding whether the safe harbor protects a transfer that passes *through* a covered entity, where the entity only acts as a conduit and has no beneficial interest in the property transferred. In *Merit Management*, the Court held that the safe harbor does not apply when a covered entity only acts as a conduit, and that the safe harbor only applies when the "relevant transfer" (i.e., the "overarching" transfer sought to be avoided) is by, to or for the benefit of a covered entity. As a result, the Court held that the safe harbor did not protect a private securities transaction where neither the buyer nor the seller was a covered entity, even though the funds passed through covered entities.

The Bankruptcy Code "Safe Harbor"

The Bankruptcy Code permits a trustee to bring claims to "avoid" (or undo) for the benefit of the bankruptcy estate certain prepetition transfers or obligations, including claims to avoid a preference (11 U.S.C. § 547) or fraudulent transfer (11 U.S.C. § 548(a)). Section 546(e) limits those avoidance powers by providing that, "[n]otwithstanding" the trustee's avoidance powers, "the trustee may not avoid a transfer that is" (1) a "margin payment" or "settlement payment" "made by or to (or for the benefit of)" a covered entity, or (2) "a transfer made by or to (or for the benefit of)" a covered entity "in connection with a securities contract . . . or forward contract." 11 U.S.C. § 546(e). The sole exception to the safe harbor is a claim for "actual fraudulent transfer" under § 548(a)(1)(A). *Id*.

Background

Merit Management involved the acquisition of a "racino" (a combined horse racing and casino business) by its competitor. To consummate the transaction, the buyer's bank wired $55 million to another bank that acted as a third-party escrow agent, which disbursed the funds to the seller's shareholders in exchange for their stock in the seller. The buyer subsequently filed for Chapter 11 bankruptcy protection and a litigation trust was established pursuant to the buyer's confirmed reorganization plan. The trustee sued one of the selling shareholders that received $16.5 million from the buyer, alleging that the transaction was a constructive fraudulent transfer under § 548(a)(1)(B) because the buyer was insolvent at the time of the purchase and "significantly overpaid" for the stock.

The district court held that the safe harbor barred the fraudulent transfer claim because the transaction was a securities settlement payment involving intermediate transfers "by" and "to" covered entities (the banks). The Seventh Circuit reversed, holding that the safe harbor did not apply because the banks only acted as conduits and neither the buyer nor the shareholder was a covered entity. In so holding, the Seventh Circuit diverged from other circuits that had applied the safe harbor to transactions consummated through a covered entity acting as a conduit.[1] Those circuits interpreted the disjunctive language in the safe harbor that protects transfers "by or to (or for the benefit of)" a covered entity to mean that a transfer "by" or "to" a covered entity is protected even if the transfer is not "for the benefit of" the covered entity. The Supreme Court granted *certiorari* to settle the circuit split.

The Supreme Court Holds That the Safe Harbor Does Not Protect a Transfer When a Covered Entity Only Acts as a Conduit

The Supreme Court affirmed the Seventh Circuit's decision, holding that the safe harbor does not protect a transfer when a covered entity only acts as a conduit. The crux of the decision is that a safe harbor analysis must focus on whether the "relevant transfer," meaning the "overarching" or "end-to-end" transfer that the trustee seeks to avoid, was by, to or for the benefit of a covered entity. Whether an intermediate or "component" transfer was made by or to a covered entity is "simply irrelevant to the analysis under § 546(e)."[2] The Court reasoned that, as an express limitation on the trustee's avoidance powers, § 546(e) must be applied in relation to the trustee's exercise of those powers with respect to the transfer that the trustee seeks to avoid, not component transfers that the trustee does not seek to avoid.[3] In the case before it, because the trustee sought to avoid the "end-to-end" transfer from the buyer to the shareholder, and neither was a covered entity, the safe harbor did not apply.

The Court Avoids Adjudicating a Potentially Significant Defense

The shareholder did not argue in the lower courts that the buyer or the shareholder was a covered entity. In its briefing in the Supreme Court, the shareholder argued that the buyer and seller were both covered entities because they were customers of the banks that facilitated the transaction, and the definition of "financial institution" in 11 U.S.C. § 101(22)(A) includes a "customer" of a financial institution when the institution "is acting as agent or custodian for a customer." During oral argument, Justice Breyer indicated that he might have been receptive to that potentially dispositive argument. However, the decision expressly avoids adjudicating the argument on the basis that the shareholder raised the point "only in footnotes and did not argue that it somehow dictates the outcome in this case." *Id*. at n. 2. As a result, the "customer-as-financial-institution defense" will likely be litigated in the lower courts going forward.

Impact of *Merit Management*

As a result of *Merit Management*, parties to securities and commodities transactions should expect that, in the event of a bankruptcy filing, the safe harbor will not protect a transaction unless the transferor, transferee or beneficiary of the "overarching" transfer is a covered entity. Routing a transfer through a covered entity will no longer protect the transaction. Given the increased importance placed on whether a party to the overarching transfer is a covered entity, *Merit Management* may lead to a new wave of litigation regarding the scope of the covered entities, including the circumstances in which the customer of a financial institution constitutes a covered entity, and related planning strategies to fall within such scope.

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[1] *See, e.g.*, *In re Quebecor World (USA) Inc.*, 719 F. 3d 94, 99 (2d Cir. 2013); *In re QSI Holdings, Inc.*, 571 F. 3d 545, 551 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F. 3d 981, 987 (8th Cir. 2009); *In re Resorts Int'l, Inc.*, 181 F. 3d 505, 516 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F. 2d 1230, 1240 (10th Cir. 1991).

[2] Decision at p. 14.

[3] *See id*. at pp. 11-14 ("If a trustee properly identifies an avoidable transfer . . . 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). . . .").

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or the following authors:

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