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Intermediate Transfers May Be Safe From 546(e) Safe Harbor

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Last week, the U.S. Supreme Court heard the oral argument in Merit Management Group v. FTI Consulting. The court is reviewing the Seventh Circuit's decision holding that the safe harbor of Section 546(e) of the Bankruptcy Code does not protect from avoidance a transfer that is conducted through a financial institution (or other qualifying entity) where that entity is neither the debtor nor the transferee but acts merely as the conduit for the transfer.[1] The Seventh Circuit's decision splits from the Second,[2] Third,[3] Sixth,[4] Eighth[5] and Tenth[6] Circuits, but is consistent with a two-decade-old decision of the Eleventh Circuit.[7]

Under Chapter 5 of the Bankruptcy Code, bankruptcy trustees have the power to avoid certain types of transfers made by an insolvent debtor. The broad purpose of a trustee's avoidance powers is to ensure the fundamental bankruptcy policies of maximizing the bankruptcy estate and equality of distribution among creditors similarly situated. The safe harbor of Bankruptcy Code Section 546(e) is one of a number of provisions in Chapter 5 that limit a trustee's avoidance powers. Section 546(e) prevents a bankruptcy trustee from avoiding a transfer that is a "margin payment" or a "settlement payment" "made by or to (or for the benefit of)" a "financial institution," "commodity broker," "forward contract merchant," "stockbroker," "financial participant" or "securities clearing agency" (as those terms are defined in the Bankruptcy Code). It also protects transfers "made by or to (or for the benefit of)" the same types of entities "in connection with" a "securities contract," "commodity contract" or "forward contract."[8]

The case arises out of a bankruptcy trustee's action to avoid as a fraudulent transfer a $16.5 million payment by the debtor, Valley View Downs — an aspiring owner of a "racino" (a combination horse track and casino establishment), to Merit Management in exchange for Merit's shares in Bedford Downs, a racino industry competitor. The transfer was effected through Citizens Bank, acting as escrow agent, and Credit Suisse, serving as lender.

The parties concede that neither Valley View nor Merit Management is a "financial institution" or other qualified entity enumerated in Section 546(e). Instead, Merit takes the position that the transfer sought to be avoided by the trustee (i.e., the transfer by Valley View to Merit) is protected by the safe harbor because it involved three transfers "made by or to" institutions qualifying for Section 546(e) protection: a transfer by Credit Suisse (the lender) to Citizens Bank (the escrow agent) and two transfers by Citizens Bank to Merit.[9] On the other hand, the trustee takes the position that Section 546(e) is an exception to the trustee's avoidance power and, as such, the "transfer" that the trustee "may not avoid" under

Section 546(e) must be the same transfer that the trustee seeks to avoid under one of the five avoidance powers cross-referenced in Section 546(e) — in this case, the end-to-end transfer by Valley View to Merit.[10] The trustee did not seek to avoid the component parts of the transfer by Valley View to Merit (i.e., any of the three transfers Merit identified as "made by or to" institutions qualifying for Section 546(e) protection).[11] Thus, according to the trustee, the safe harbor of Section 546(e) does not protect the transfer by Valley View to Merit from avoidance.

The Supreme Court's decision may turn on whether it finds that the language of Section 546(e) is ambiguous and looks to the statute's context and purpose, as the Seventh Circuit did. The Seventh Circuit found that Chapter 5 of the Bankruptcy Code "creates both a system for avoiding transfers and a safe harbor from avoidance — logically these are two sides of the same coin," and that therefore the safe harbor should be understood "as applying to the transfers that are eligible for avoidance in the first place."[12] The Seventh Circuit explained that its interpretation is consistent with the safe harbor's purpose of "reducing 'systemic risk in the financial marketplace,'"[13] as the avoidance of the transfer would have no impact on Credit Suisse, Citizens Bank or any other entity named in Section 546(e).

Based on the justices' questions at the oral argument last week, the odds are good that the Supreme Court will agree with the Seventh Circuit. The justices appeared to agree that the safe harbor should apply to the transfer that the trustee seeks to avoid, rather than an intermediate transfer. For example, Justice Ruth Bader Ginsburg questioned why, if the trustee's claim is that Merit received money that otherwise would have been available for distribution to creditors, it should matter that the transmission was through banks, rather than handed directly by Valley View to Merit, and how either bank was at risk as a result of the trustee's avoidance action.[14] Justice Samuel Alito asked why the safe harbor should not apply to the transfer sought to be avoided, as opposed to intermediate transfers that are not themselves subject to avoidance;[15] Justice Anthony Kennedy and Justice Ginsburg joined in on this line of questioning. Chief Justice John Roberts and Justice Stephen Breyer expressed concern about the scope of the safe harbor if it were to protect a transfer by or to a financial institution (or other named entity) serving merely as the conduit for the transfer.[16] Justice Sonia Sotomayor weighed in that Section 550 of the Bankruptcy Code (which governs a trustee's power to recover a transfer that has been avoided) "works very strongly against" applying 546(e) to protect a transfer where the financial institution is merely the conduit for the transfer because Section 550 does not allow a trustee to recover from a conduit or intermediary.[17] Justice Elena Kagan observed that it "seems odd to read [Section 546(e)] in any other way than to start with the transfer that the trustee seeks to avoid."[18] Overall, the justices appeared to reject Merit's position that the safe harbor of Section 546(e) should shield an end-to-end transfer that a trustee seeks to avoid based on an intermediate transfer that is not sought to be avoided.

The Supreme Court's decision will have significant impact in the leveraged buyout context. Currently, in the Second, Third, Sixth, Eighth and Tenth Circuits, former shareholders who have received payments as part of a leveraged buyout that renders a company insolvent are protected by Section 546(e) from avoidance of such payments if they are made through a financial institution or other qualified entity that is a conduit for the payment. If the Supreme Court sides with the Seventh and Eleventh Circuits, the use of a financial institution or other qualified entity (such as a national securities clearance and settlement system) as a conduit will no longer provide a safe harbor.[19]

The National Association of Bankruptcy Trustees filed an amicus brief in support of the respondent in which it warns that Merit's application of Section 546(e) would prevent a trustee from attempting to unwind a failed leveraged buyout — even a purely private one, as most are — despite the unique hazard to unsecured creditors that these transactions pose.[20] Several prominent bankruptcy law professors

also filed a separate amicus brief in support of the respondent. These law professors agree with the Seventh and Eleventh Circuits that the Bankruptcy Code's system for avoiding transfers and safe harbor from avoidance are two sides of the same coin — the safe harbor applies only to transfers that are otherwise eligible for avoidance in the first place.[21] They view the contrary decisions of other circuits as mistaken applications of the safe harbor to protect transactions that pose no threat to the integrity of the security settlement and clearance process — the purpose for which the safe harbor was enacted.[22]

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[1] FTI Consulting Inc. v. Merit Management Group LP, 830 F.3d 690 (7th Cir. 2016).

[2] In re Tribune Co. Fraudulent Conveyance Litigation, 818 F.3d 98 (2d Cir. 2016); Official Comm. Of Unsecured Creditors of Quebecor World (U.S.A.) Inc. v. American Life Ins. Co. (In re Quebecor World (USA) Inc.), 719 F.3d 94 (2d Cir 2013); Enron Creditors Recovery Corp. v. Alfa SAB de CV (In re Enron Creditors Recovery Corp.), 651 F.3d 329 (2d Cir. 2011).

[3] Lowenschuss v. Resorts Int'l Inc. (In re Resorts Int'l Inc.), 181 F.3d 505, 516 (3d Cir. 1999).

[4] QSI Holdings Inc. v. Alford (In re QSI Holdings Inc.), 571 F.3d 545 (6th Cir. 2009).

[5] Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009).

[6] Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.), 952 F.2d 1230 (10th Cir. 1991).

[7] Munford v. Valuation Research Corp. (In re Munford Inc.), 98 F.3d 604 (11th Cir. 1996).

[8] 11 U.S.C. § 546(e).

[9] Brief for Petitioner at 2, Merit Management Group v. FTI Consulting, No. 16-784 (July 13, 2017).

[10] Brief for Respondent at 2, Merit Management Group v. FTI Consulting, No. 16-784 (Sept. 11, 2017).

[11] Id.

[12] FTI Consulting Inc., 830 F.3d at 694.

[13] Id. at 696 (citing H.R. Rep. 109-31(i), at 3, reprinted in 2005 U.S.C.C.A.N. 88, 89).

[14] Transcript of Oral Argument at 5-6, Merit Management Group v. FTI Consulting, (2017) (No. 16-784).

[15] Transcript of Oral Argument at 10, Merit Management Group v. FTI Consulting, (2017) (No. 16-784).

[16] Transcript of Oral Argument at 12, Merit Management Group v. FTI Consulting, (2017) (No. 16-784).

[17] Transcript of Oral Argument at 20, Merit Management Group v. FTI Consulting, (2017) (No. 16-784).

[18] Transcript of Oral Argument at 27, Merit Management Group v. FTI Consulting, (2017) (No. 16-784).

[19] For example, the Supreme Court's decision may materially affect former shareholders and unsecured creditors of the Tribune Company and the Lyondell Chemical Company, both of which went into bankruptcy following failed leveraged buyouts. The former shareholders currently are defendants in constructive fraudulent transfer actions seeking to avoid and recover settlement payments for their shares, effected through national securities clearance and settlement systems. The Second Circuit's decision in the Tribune case, holding that Section 546(e) bars the avoidance and recovery of these payments, is inconsistent with the Seventh Circuit's decision, and a petition for certiorari review of the Second Circuit decision is pending. In re Tribune Co. Fraudulent Conveyance Litigation, 818 F.3d 98 (2d Cir. 2016). The Tribune and Lyondell former shareholders submitted an amicus brief in support of the petitioners, and the Tribune unsecured creditors submitted a brief in support of the respondent.

[20] Brief of National Association of Bankruptcy Trustees as Amici Curiae Supporting Respondent, at 3, 13-18, Merit Management Group v. FTI Consulting, No. 16-784 (Sept. 18, 2017).

[21] Brief of Bankruptcy Law Professors Ralph Brubaker, et al. as Amici Curiae Supporting Respondent, at 4, Merit Management Group v. FTI Consulting, No. 16-784 (Sept. 18, 2017).

[22] Id. at 1-2.