

# Supreme Court Holds Section 546(e) Safe Harbor Does Not Apply To All Transfers Made Through Financial Institutions

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Earlier this week, the U.S. Supreme Court issued its unanimous decision in *Merit Management Group, LP v. FTI Consulting, Inc.*, holding that 11 U.S.C § 546(e), which creates a safe harbor against the avoidance of certain transfers made “by or to (or for the benefit of)” financial institutions, does not apply merely because the challenged transfer is completed through a financial institution.<sup>1</sup> This holding effectively overrules prior decisions of the Second, Third, Sixth, Eighth and Tenth Circuits that had adopted a more expansive view of the safe harbor protection.

In reaching its conclusion, the Court focused heavily on the text of the statute, instructing courts to focus their analysis on the “end-to-end transfer” the trustee seeks to avoid rather than any individual transaction the transfer comprises. By way of example, the Court found that Section 546(e) would not prevent a trustee from avoiding a transfer between two non-financial institutions (“A→D”), even where that transfer was effectuated through financial institutions as intermediaries (“A→B→C→D”).

The decision is the Supreme Court’s first to address the safe harbors under the U.S. Bankruptcy Code. As a result, although the particular holding of *Merit* may not be directly applicable to the rights of financial counterparties under qualified financial contracts, the case may affect how lower courts interpret the safe harbors more generally.

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<sup>1</sup> [Merit Mgmt. Grp., LP v. FTI Consulting, Inc.](#), No. 16-784 (Feb. 27, 2018).  
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## **Background**

In 2003, two racetracks, Valley View Downs, LP and Bedford Downs, both sought to operate “racinos,” combination horse track casinos. However, the operation of racinos required a harness-racing license, and, at the time, Pennsylvania had only one such license available. Rather than compete with Bedford Downs for the license, Valley View acquired all of Bedford Downs’ shares for \$55 million in a cash-for-stock agreement.<sup>2</sup>

In order to finance the acquisition, Valley View borrowed funds from a lending bank and several other lenders. At closing, the lending bank transferred the acquisition price to another bank, which acted as the escrow agent. Then, the escrow bank transferred cash payments to the shareholders of Bedford Downs, including \$16.5 million to Merit Management Group.<sup>3</sup>

Although Valley View was awarded the harness-racing license, it failed to acquire the gambling license it needed to operate the racino, resulting in a bankruptcy filing. FTI Consulting, Inc., trustee of the debtor’s litigation trust, subsequently sought to avoid the \$16.5 million transfer to Merit as a constructively fraudulent transfer under Section 548(a)(1)(B) of the Bankruptcy Code.<sup>4</sup>

Merit moved to dismiss the trustee’s action, arguing that the Bankruptcy Code’s safe harbors immunized the transfer from claims of constructive fraudulent conveyance. Specifically, Merit pointed to Section 546(e), which bars a bankruptcy trustee from avoiding under Section 548(a)(1)(B) (among other provisions) a settlement payment or transfer in connection with a securities contract, if the settlement payment or transfer is “made by or to (or for the benefit of) a . . .

financial institution” or another kind of entity listed in Section 546(e).<sup>5</sup>

The trustee did not dispute that the transfer of \$16.5 million was a settlement payment or a transfer in connection with a securities contract. However, it challenged that the transfer was “by or to” a “financial institution” or other entity listed in Section 546(e) because neither Valley View nor Merit was such an entity.<sup>6</sup> Merit responded that neither Valley View nor Merit needed to be such an entity in order for the transfer to fall within the protections of Section 546(e) because the lending banks and escrow bank were “financial institutions” within the meaning of the Bankruptcy Code, and the \$16.5 million was transferred by the lending bank and both by and to the escrow bank.<sup>7</sup> The district court agreed with Merit and dismissed the trustee’s claims.<sup>8</sup>

On appeal, the Seventh Circuit reversed and held that Section 546(e) does not protect transfers “that are simply conducted *through* financial institutions (or other entities named in Section 546(e)), where the entity is neither the debtor nor the transferee but only the conduit.”<sup>9</sup>

In addition to focusing on the “ambiguous” text of Section 546(e), the Seventh Circuit focused on its purpose, stating 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.”<sup>10</sup> By contrast, the case before it presented no systemic risk concerns.

As the Seventh Circuit acknowledged, its holding was a departure from the views of a number of its sister circuits. The Second, Third, Sixth, Eighth and Tenth Circuits have held that Section 546(e) applied even

<sup>2</sup> FTI Consulting, Inc. v. Merit Mgmt. Grp., LP., 541 B.R. 850, 852 (N.D. Ill. 2015).

<sup>3</sup> Id.

<sup>4</sup> Id.

<sup>5</sup> Id.; see also 11 U.S.C. § 546(e) (including “commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency” as covered entities).

<sup>6</sup> FTI Consulting, Inc., 541 B.R. at 853-54.

<sup>7</sup> Id. at 854.

<sup>8</sup> Id. at 860.

<sup>9</sup> FTI Consulting Inc. v. Merit Mgmt. Grp., LP., 830 F.3d 690, 691 (7<sup>th</sup> Cir. 2016).

<sup>10</sup> Id. at 696.

where the financial institution acts merely as a conduit.<sup>11</sup>

### **The Supreme Court's Decision**

In a unanimous decision authored by Justice Sotomayor, the Court affirmed the Seventh Circuit's decision, concluding Section 546(e) does not apply to the trustee's attempt to avoid the transfer between Valley View and Merit.<sup>12</sup> In coming to this conclusion, the Court did not address the question often framed in safe harbor litigation: whether Section 546(e) should apply where a financial institution is a "mere conduit" or intermediary to a transfer.<sup>13</sup> Nor did the Court find the language of Section 546(e) ambiguous, as the Seventh Circuit did, or engage in a policy-driven analysis employed by other courts.

Instead, the Court reframed the question and adopted the arguments of the trustee in holding that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid, which in this case was the "end-to-end" transfer (*i.e.*, A→D) and that courts should not "look to any component parts of the overarching transfer" (*i.e.*, A→B→C→D).<sup>14</sup>

The Court's analysis opened with a review of the text of Section 546(e), which begins with "[n]otwithstanding section 544, 545, 547, 548(a)(1)(B), and 548(b) of this title."<sup>15</sup> According to the Court, this language makes it clear that the safe harbor is nothing more than an exception to a trustee's avoidance powers under the Bankruptcy Code.<sup>16</sup> The Court found that "by referring back to a specific type of transfer that falls within the avoiding power, Congress signaled that the exception applies to the

overarching transfer that the trustee seeks to avoid," and not any individual transaction that transfer comprises.<sup>17</sup>

Continuing its textual analysis, the Court next seized on Section 546(e)'s language that the trustee may not avoid "a transfer that *is*" a settlement payment or made in connection with a securities contract.<sup>18</sup> In the Court's view, this "dispels [any] doubt" that the statute's focus is the overall transfer rather than its constituent parts, because the statute focuses only on transfers that *are* settlement payments or made in connections with securities contracts, not transfers that "involve" or "comprise" them.<sup>19</sup> Thus, the Court held, "the transfer that the trustee seeks to avoid [is] the relevant transfer for consideration of the § 546(e) safe harbor criteria."<sup>20</sup>

Responding to concerns expressed at oral argument that this approach could allow a trustee to sidestep Section 546(e) by creatively defining the "relevant transfer," the Court cautioned that a trustee "is not free to define the transfer that it seeks to avoid in any way it chooses," but instead must satisfy the criteria set out in the Bankruptcy Code.<sup>21</sup> This would leave a defendant free to argue that a trustee failed to properly identify an avoidable transfer, "including any available arguments concerning the role of component parts of the transfer."<sup>22</sup>

In arriving at its interpretation of Section 546(e), the Court rejected a number of counterarguments. First, the Court rejected Merit's suggestion that the 2006 addition of "(or for the benefit of)" language in Section 546(e) demonstrated Congress's desire to legislatively overrule *In re Munford, Inc.*,<sup>23</sup> in which

<sup>11</sup> *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *In re Resorts Int'l, Inc.*, 181 F.3d 505 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F.3d 1230 (10th Cir. 1991).

<sup>12</sup> *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, No. 16-784, slip op. at 2 (Feb. 27, 2018).

<sup>13</sup> *Compare Merit Mgmt. Grp.*, slip op. at 10 *with FTI Consulting Inc.*, 830 F.3d at 691.

<sup>14</sup> *Merit Mgmt. Grp.*, slip op. at 2.

<sup>15</sup> 11 U.S.C. § 546(e).

<sup>16</sup> *Merit Mgmt. Grp.*, slip op. at 11.

<sup>17</sup> *Id.* This reading was further supported by the final clause of Section 546(e), which creates an exception to the exception for actually fraudulent transfers under Section 548(a)(1)(A). *Id.*

<sup>18</sup> *Id.* at 12-13 (emphasis in original).

<sup>19</sup> *Id.* at 13.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 14.

<sup>22</sup> *Id.*

<sup>23</sup> *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996)

the Eleventh Circuit held that Section 546(e) was inapplicable where financial institutions served as mere intermediaries.<sup>24</sup> After observing that Merit cited no authority for this contention, the Court pointed to the avoidance provisions in the Bankruptcy Code that include the language “(or for the benefit of),” reasoning that Congress may have added that phrase in 2006 to bring Section 546(e) in line with other provisions of the Bankruptcy Code.<sup>25</sup>

The Court also addressed Merit’s argument that the statute’s inclusion of securities clearing agencies, the definition of which includes “an intermediary in payments or deliveries made in connection with securities transactions,” demonstrates that Congress intended Section 546(e) to be interpreted without regard to an entity’s beneficial interest in the transfer.<sup>26</sup> Merit argued that that to hold otherwise would render portions of the statute “ineffectual or superfluous.”<sup>27</sup> Rejecting this contention, the Court determined that if a trustee sought to avoid a transfer “made by or to (or for the benefit of)” a securities clearing agency that would otherwise be covered by Section 546(e), the safe harbor would bar such an action regardless of whether the securities clearing agency was acting as an intermediary.<sup>28</sup> Contrary to Merit’s assertion that this interpretation would render portions of the statute superfluous, the Court found that its “reading gives full effect to the text of § 546(e).”<sup>29</sup>

Finally, the Court briefly turned to the underlying purpose of Section 546(e). Merit argued that Congress intended the statute to be a broad, prophylactic measure to protect the securities and commodities markets and that it would be antithetical to that purpose for its application to depend on “the identity of the investor and the manner in which it held its investment,” rather than “the nature of the transaction generally.”<sup>30</sup> The Court showed little interest in analyzing the purpose of the safe harbor, stating that even if this were the type of case in which the Court

would consider statutory purpose, the statute flatly contradicted Merit’s position, because it specifically targeted transfers “by or to (or for the benefit of)” financial institutions.<sup>31</sup> The Court suggested that if Congress had intended Section 546(e) to apply to transfers made “through” a financial institution, rather than simply by or to or for the benefit of, it would have included language to that effect.<sup>32</sup> Thus, Merit’s argument amounted to disagreement with Section 546(e) itself.

Having concluded that the proper focus is on the transfer the trustee seeks to avoid, and that the transfer at issue in the instant case was the purchase of Bedford Downs’ stock by Valley View from Merit, the Court concluded that “[b]ecause the parties do not contend that either Valley View or Merit is a “financial institution” or other covered entity, the transfer falls outside of the § 546(e) safe harbor.”<sup>33</sup>

### **Implications**

The Court’s decision is likely to have a significant impact on the application of the safe harbors to avoidance actions and related litigation.

- The Court’s heavy focus on “the transfer that the trustee seeks to avoid” as the relevant transfer will cause debtors or trustees to strategically frame avoidance actions in order to limit the scope of the safe harbor. As the Court acknowledges, however, they will continue to be constrained by the scope of avoidance powers granted in the Bankruptcy Code. We therefore expect more aggressive litigation tactics, especially by out-of-the-money creditor constituencies.
- The availability of the Section 546(e) safe harbor in leveraged buyouts and other stock acquisitions will be more limited. In many instances the courts will not have to focus on

<sup>24</sup> Merit Mgmt. Grp., slip op. at 15.

<sup>25</sup> Id. at 15-16.

<sup>26</sup> Id. at 17.

<sup>27</sup> Id. at 16.

<sup>28</sup> Id. at 17.

<sup>29</sup> Id.

<sup>30</sup> Id.

<sup>31</sup> Id. at 18.

<sup>32</sup> Id.

<sup>33</sup> Id. at 19.

the distinction between public and private sales because they will not need to reach the question of whether a transfer is a settlement payment or in connection with a securities contract.<sup>34</sup> The decision will likely have substantially less relevance to more traditional applications of the safe harbor (*i.e.*, cases involving transfers made to financial institutions and other covered entities as principals).

- By interpreting the federal safe harbors more narrowly, the Court’s decision will make state law-based workarounds less relevant. Recently, there have been a number of cases in which bankruptcy estates, particularly in the LBO context, have abandoned fraudulent conveyance-based avoidance claims to allow a creditor trust to bring state law-based fraudulent conveyance claims outside of the federal safe harbor.<sup>35</sup> Now that *Merit* has limited the scope of the safe harbor in the LBO or acquisition contexts, there is less incentive to take this state law approach.
- The Court chose not to rely on the policy-based arguments relating to the existence or non-existence of “systemic risk” to markets. Instead, the Court focused on the text of Section 546(e).<sup>36</sup>
- It remains to be seen what effect the Court’s decision will have on other safe harbor disputes, including, for example, what constitutes a qualified financial contract covered by the statute. These issues were not

before the Court in *Merit*, but will obviously continue to be important issues.

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<sup>34</sup> See, e.g., *In re MacMenamin’s Grill Ltd.*, 450 B.R. 414, 430 n.19 (Bankr. S.D.N.Y. 2011) (refusing to apply Section 546(e) to a transfer and noting that “[n]othing in the legislative history suggests that Congress intended the 2006 amendment to exempt lenders from a trustee’s avoidance powers, as here, no party was acting in its capacity as a participant in a securities market and the avoidance of the transaction would not pose any risk to any securities market”).

<sup>35</sup> At the current time, there is a split of authority as to whether Section 546(e) applies to state law fraudulent conveyance claims brought by creditors. Compare *In re Tribune Fraudulent Conveyance Litig.*, 818 F.3d. 98 (2d Cir. 2016) with *In re Physiotherapy Holdings, Inc.*, Civ. No. 13-12965 (KG), 2016 WL 3611831 (Bankr. D. Del. June 20, 2016). While *Merit* did not address this issue, it remains to be seen how litigants and courts alike attempt to make use of its reasoning in that ongoing debate.

<sup>36</sup> *Merit Mgmt. Grp.*, slip op. at 10.