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US Supreme Court Limits Securities Safe Harbor Protection From Bankruptcy Clawback Suits

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The securities safe harbor protection of Bankruptcy Code ("Code") § 546(e) does not protect allegedly fraudulent "transfers in which financial institutions served as mere conduits," held the U.S. Supreme Court on Feb. 27, 2018. *Merit Management Group LP v. FTI Consulting Inc.*, 2018 WL 1054879, *7 (2018). Affirming the Seventh Circuit's reinstatement of the bankruptcy trustee's complaint alleging the insolvent debtor's overpayment for a stock interest, the Court found the payment not covered by §546(e) and thus recoverable. The district court had dismissed the trustee's claim. See *FTI Consulting Inc. v. Merit Management Group LP*, 830 F.3d 690 (7th Cir. 2016), *reversing* 541 B.R. 850 (N.D. Ill. 2015).

Code § 546(e) provides a defense to constructive fraudulent transfer and preference claims arising out of securities transactions. Defendants often assert the defense when bankruptcy trustees seek to recover pre-bankruptcy payments by a corporation to its shareholders in a leveraged buyout. The defense requires, among other things, that the payment be made "by or to (or for the benefit of)" certain qualified transferees, including a "financial institution." Because security trades are commonly settled through financial institutions, most appellate courts had found the presence of a financial institution, even if it had no beneficial interest in the underlying transaction, to be sufficient to meet the Code's requirement that the transfer be "made by or to" a financial institution.

Relevance

The Court had granted certiorari in *FTI* to "resolve a conflict among the Circuit Courts as to the proper application of the § 546(e) safe harbor." 2018 WL 1054879 at *7. Appellate courts had generally agreed on the vitality and breadth of the safe harbor defense contained in § 546(e). It insulates from the trustee's fraudulent transfer or preference attack a "settlement payment," "margin payment" or transfer related to a "securities contract . . . made by or to (or for the benefit of)" certain protected parties, including "financial institutions," except when the debtor makes the payment with "actual intent to hinder, delay or defraud" creditors under Code § 548(a)(1)(A). As the Seventh Circuit noted below, neither the debtor nor the debtor transferee in *FTI* had been "parties in the securities industry," but were simply corporations that wanted to exchange money for privately held stock. 830 F.3d at 696.

The Seventh Circuit in *FTI* had refused to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution . . . as a conduit for funds." 830 F.3d at 697, agreeing with *In re Munford Inc.*, 98 F.3d 604, 610 (11th Cir. 1996) (2-1) (Code § 546(e) inapplicable to payments made by debtor to shareholders when financial institutions acted as mere conduits). As the Seventh Circuit stressed, Congress never said "that acting as a conduit for a transaction between non-named entities is enough to qualify for the safe harbor . . . ." 830 F.3d at 697. The Seventh Circuit, of course, recognized that it was "taking a different position from the one adopted by five of our sister circuits, which have interpreted § 546(e) to include the conduit situation." *Id*.

Facts
"Buyer" (the debtor here) agreed to buy all of the shares of an entity known as B from certain entities, including "Seller," a 30 percent shareholder of B, for a total of $55 million, borrowing the funds from a group of lenders, with the transfer of the funds flowing through "Bank." Thus, Buyer and Seller were corporate entities "that wanted to exchange money for privately held stock." *Id*. at 696.

After Buyer later filed a Chapter 11 petition, its litigation trustee sued Seller under Code § 548 and applicable state law to recover $16.5 million, representing Seller's 30 percent equity interest paid by Buyer to Seller. Seller argued that the transfer was "made by or to (or for the benefit of)" an entity named in Code § 546(e), namely, a "financial institution" (i.e., Bank), and was, therefore, protected by the safe harbor. Because the funds passed through Bank, the district court dismissed the trustee's complaint, agreeing with Seller that the transfer had passed through a financial institution. Seller "did not rely on its own status, because neither Buyer nor Seller contended that either [of them] is a 'financial institution' or other covered entity . . ." 2018 WL at *12. Rather, Seller argued that the safe harbor applied because "the component parts [of the stock sale] include transactions by and to financial institutions." *Id*., at *7.

Analysis
The Supreme Court examined "the language of § 546(e), the specific context in which that language is used, and [its] broader statutory structure . . ." *Id.*, at *8. In its view, "the relevant transfer . . . is the overarching transfer that the trustee seeks to avoid under one of the [Code's] substantive avoidance provisions". Here, "the only relevant transfer for . . . the safe harbor inquiry is the overarching transfer between [Buyer] and [Seller] of $16.5 million for purchase of the stock [—] the transfer that the trustee seeks to avoid . . . . [T]hat transfer was not made by, to, or for the benefit of a financial institution." *Id*. at *7.

Statutory Language
First, said the Court, the "text reminds us that the focus of the inquiry is the transfer that the trustee seeks to avoid." *Id*. at *8. Because Code § 548 refers to the avoidance of transfers to or for the benefit of entities subject to fraudulent transfer liability, "Congress signaled that the [§ 546(e)] exception applies to the [challenged] overarching transfer . . ., not any component part of that transfer." *Id*. Thus, the "safe harbor provides that 'the trustee may not avoid' certain transfers." *Id*., at *9. The "trustee may not avoid . . . a transfer that *is*," said the Court, "either a 'settlement payment' or made 'in connection with a securities contract'." *Id*. According to the Court, § 546(e) applies only to a transfer that is a covered "securities transaction"; "Not a transfer that involves. Not a transfer that comprises." *Id*. The "otherwise avoidable transfer [must] itself be a transfer that meets the safe-harbor criteria." *Id*.

Statutory Structure
A trustee asserting an avoiding power (e.g., preference, fraudulent transfer) must identify the challenged transfer. But the defendant "is free to argue that the trustee failed to properly identify an avoidable transfer under the Code, including any available arguments concerning the role of component parts of the transfer." *Id*., at *10. If the trustee does properly identify an avoidable transfer, though, the court may not "examine the relevance of component parts," which "are simply irrelevant to the analysis under § 546(e)." *Id*. Here, Seller argued that the district court could not "ignore" the intermediate Bank "component parts" of Buyer's payment. *Id*.

The Supreme Court rejected Seller's argument "that a transaction 'by or to' a financial institution such as [Bank] would meet the requirements of § 546(e) [when] the financial institution is acting as an intermediary without a beneficial interest in the transfer." *Id*., at *10. In its view, neither the "Code or legislative history" shows "that Congress sought to abrogate [the Eleventh Circuit's] *Munford*" decision. *Id*.

More important, said the Court, if the challenged transfer "was made 'by' or 'to' a securities clearing agency . . ., then § 546(e) *will* bar avoidance . . . without regard to whether the entity acted only as an intermediary . . . [Also] [t]he safe harbor will . . . bar avoidance if the transfer was made 'for the benefit of' that securities clearing agency, even if it was not made 'by' or to that entity." *Id*., at *11 (emphasis added). But the Court did not address "the impact, if any, [Code] § 101(22)(A) would have in the application of the § 546(e) safe harbor," for neither party claimed to be a "financial institution" due to its "customer" status. *Id*., at *5n.2.

Legislative Purpose

The Court finally rejected Seller's reliance on Congress' "purpose in enacting the safe harbor." *Id*., at *12. Declining to address the argument, the Court explained that Seller had, in any event, "failed to support" its argument which "the plain language of the safe harbor" contradicts. *Id*. Although the safe harbor insulates certain securities transactions "made by or to (or for the benefit of)" covered entities, transfers *through* a covered entity "appear nowhere in the statute" (emphasis added). *Id*.

Comment

FTI confirms that, on certain facts, entities defending fraudulent transfer claims will not be able to rely on the § 546(e) securities safe harbor defense solely because of the flow of funds through a "financial institution" intermediary. These defendants will still be able to argue that the § 546(e) safe harbor applies because of their own status as a "financial institution," "financial participant" or other protected entity, which will leave the safe harbor defense available to many large or active players in the financial markets. *FTI* also expressly leaves open the possibility that any "customer" of a "financial institution" is also a "financial institution" for purposes of the § 546(e) safe harbor.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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