

ALERTS

Seventh Circuit Limits Bankruptcy Safe Harbor Protection

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The safe harbor protection of Bankruptcy Code (“Code”) §546(e) does not protect “transfers that are simply conducted *through* financial institutions,” held the U.S. Court of Appeals for the Seventh Circuit on July 28, 2016. *FTI Consulting Inc. v. Merit Management Group LP*, 2016 WL 4036408, *1 (7th Cir. July 28, 2016). Because the debtor’s transfer of funds to the transferee passed through a financial institution acting only as a conduit that was not one of the parties covered by §546(e) (i.e., “commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency”), the asserted fraudulent transfer was not protected by §546(e) and was thus recoverable, said the court when reversing the district court’s dismissal of the trustee’s claim.

Relevance

Appellate courts, including the Seventh Circuit, have 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” or “margin payment” on a “securities contract,” “commodity contract,” or “forward contract ... made by or to (or for the benefit of)” certain “financial institutions,” except when the debtor makes the payment with “actual intent to hinder, delay, or defraud” creditors under Code §548(a)(1)(A).

Despite policy arguments by trustees, creditors and academics, the Courts of Appeals have generally refused to add to the Code’s plain

language. See, e.g., *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013) (*held*, payments by debtor to institutional noteholder trustee for noteholders “in exchange for private placement notes ... clearly fell within the safe harbor for ‘transfers made ... in connection with a securities contract.’”); *In re QSI Holdings, Inc.*, 57 F.3d 545, 551 (6th Cir. 2009) (bank’s role in leveraged buyout “sufficient to satisfy the requirement that the transfer was made to a financial institution,” although bank was only an exchange agent). In *FTI*, however, the Seventh Circuit 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.” 2016 WL 4036408, at *6, 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” 2016 WL 4036408, at *7. The court, of course, recognized that it was “taking a different position from the one adopted by five of our sister circuits, which have interpreted section 546(e) to include the conduit situation.” *Id.* at *6. This circuit split makes *FTI* a likely candidate for Supreme Court review.

Facts

“Buyer” 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 \$55 million, borrowing the funds from a group of lenders, with the transfer of the funds flowing through “Bank.” As the Seventh Circuit noted, “neither [Buyer] nor [Seller] were ‘parties in the securities industry,’ [but were] simply corporations that wanted to exchange money for privately held stock.” *Id.* at *6.

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] is a commodity broker, forward contract

merchant, stock broker, financial institution, financial participant, or securities clearing agency (the entities named in section 546(e)).” *Id.* at *1. Rather, Seller argued that the safe harbor applied because of “the minor involvement of [Bank and the lenders].” *Id.*

Analysis

The Seventh Circuit carefully examined the language of §546(e), its statutory context, its legislative history and its significance in the securities industry.

Statutory Language. First, said the court, the “language of the statute, standing alone ... is unclear whether the safe harbor was meant to include intermediaries, or if it is limited to what we might think of as the real parties in interest — here, [Buyer and Seller].” *Id.* at *2. Because Code §548 refers to the avoidance of transfers to or for the benefit of entities subject to fraudulent transfer liability, the court understood “the safe harbor as applying to the transfers that are eligible for avoidance in the first place.” *Id.* at *3. And “because the safe harbor is meant to protect covered entities against avoidance where it might occur, ... [§]546(e) provides a safe harbor only where the debtor has [made a transfer] to the covered entity.” *Id.* Most important, the court explained, the “\$16.5 million transferred to [Seller] ... was one made by the debtor using a bank as a conduit.” *Id.* Indeed, it is “the receipt of value [that] ... gives an entity the safe-harbor protections of 546(e) [I]t is the economic substance of the transaction that matters.” *Id.* at *4.

Relying on one of its earlier decisions, the court reasoned “that transfers ‘made by or to (or for the benefit of)’ in the context of 546(e) [apply only] to transfers made to ‘transferees’... .” *Id.* at *5, citing *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 893 (7th Cir. 1988). In that case, when a bank “acted as a financial intermediary” and “received no benefit,” the court held it was not a “transferee” and, therefore, was not liable under the Code. In other words, Bank here was not a transferee, but only a conduit, and could not be held liable.

Legislative History. When Congress created the safe harbor in 1982, “[n]othing ... indicated that the safe harbor applied to financial institutions in their capacity as intermediaries.” *Id.*, at *5. As the court had previously acknowledged in *Grede v. FCStone LLC*, 746 F.3d 244, 252 (7th Cir. 2014), Congress intended to “protect ... the market from systemic risk and allow

... parties in the securities industry to enter into transactions with greater confidence,” and to prevent “one large bankruptcy from rippling through the securities industry.” *Id.* Although the Seventh Circuit and other appellate courts have held that section 546 should be construed “broadly,” there are still “limits” on its construction. Here, neither Buyer nor Seller were “parties in the securities industry.” *Id.* at *6. “The safe harbor addresses cases where the debtor-transferor or transferee is a financial institution or the other named entity.” *Id.* Moreover, if the transfer to Seller were avoided here, “there is no evidence that it would have any impact on [the lenders, Bank] or any other bank or entity named in section 546(e).” *Id.* at *6.

Circuit Split. The Seventh Circuit acknowledged that “five of our sister circuits ... have interpreted section 546(e)” differently, but noted that the Eleventh Circuit “agrees with us.” *Id.*, citing *In re Munford*, 98 F.3d 604, 610 (11th Cir. 1996) (2-1). Despite Seller’s argument that Congress had impliedly rejected *Munford* with a 2006 amendment, the Seventh Circuit did “not believe that Congress would have jettisoned *Munford’s* rule” indirectly. Nor had Congress said “that acting as a conduit for a transaction between non-named entities is enough to qualify for the safe harbor.” *Id.* at *7.

Comment

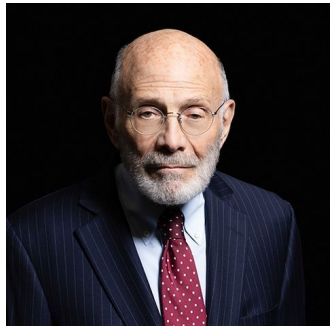
FTI confirms that entities uncovered by §546(e) will not be able to rely on the safe harbor because of the coincidental flow of funds through a “financial institution” intermediary. The Seventh and Eleventh Circuits, for example, would reverse a decision such as *AP Services LLP v. Silva*, 483 B.R. 63, 68-69, 71 (S.D.N.Y. 2012) (*held*, §546(e) required dismissal of the fraudulent transfer complaint when failed leverage buyout preceded bankruptcy; debtor transferred funds “directly to [the selling shareholder defendants’] bank accounts and [the funds] did not pass ... through a clearinghouse or [similar] intermediary.”). In contrast, as noted, the Second, Third, Sixth, Eighth and Tenth Circuits do not accept the Seventh Circuit’s analysis. The issue may still remain open in the First, Fourth, Fifth, Ninth and DC. Circuits. Only the Supreme Court can resolve this circuit split and prevent forum shopping.

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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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