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# Client Alert

Financial Restructuring & Insolvency-Related Litigation

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## Supreme Court Denies "Safe Harbor" Protection for Transfers Where Financial Institutions Are Mere Conduits

On February 27, 2018, the Supreme Court issued a unanimous decision in *Merit Management Group, LP v. FTI Consulting, Inc.*,[1] holding that the "safe harbor" encompassed in Section 546(e) of the Bankruptcy Code does not protect transfers in which a financial institution or other protected entity merely serves as conduit. For purposes of applying Section 546(e), courts are to look at the overarching transfer that the trustee seeks to avoid, rather than its various intermediate subparts. In affirming the Seventh Circuit's decision, the Supreme Court adopted a more narrow view of the safe harbor, protecting transfers made *by* or *to* — not *through* — one of financial institutions and other intermediate entities. The Supreme Court's interpretation of the safe harbor provision will, in certain circumstances, broaden bankruptcy trustees' rights to claw back transfers that were otherwise protected from avoidance based on prior rulings by lower courts.

### Background

The case arose from an agreement executed by Valley View Downs, LP and Bedford Downs Management Corporation, under which Valley View purchased all of Bedford Downs stock for $55 million. Valley View financed the purchase price through Credit Suisse and other lenders. Citizens Bank of Pennsylvania served as escrow agent and ultimately disbursed the proceeds to Bedford Downs' shareholders on behalf of Valley View. One such shareholder, Merit Management Group, LP ("Merit") received approximately $16.5 million pursuant to the agreement. Subsequently, Valley View filed a petition for Chapter 11 bankruptcy. Valley View's confirmed plan created a litigation trust run by FTI Consulting, Inc. ("FTI"), as litigation trustee.

FTI sued Merit to avoid and recover the $16.5 million payment as a constructive fraudulent transfer under Bankruptcy Code sections 544, 548(a)(1)(B), and 550. FTI argued the transfer was avoidable because Valley View was insolvent at the time of the transfer and it did not receive reasonably equivalent value in return for the stock purchase price. Merit moved for judgment on the pleadings, arguing that Bankruptcy Code section 546(e) prohibits avoidance of the transfer because the transfer was a "settlement payment … made by or to (or for the benefit of)" a covered

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"financial institution."[2] The debate thus hinged upon the interpretation of the phrase "made by or to (or for the benefit of)."

The district court granted Merit's motion for judgment on the pleadings based on the involvement of Citizens Bank and Credit Suisse. It relied on the majority view summarized in Second Circuit precedent,[3] which protected qualifying pre-petition transfers made by, to, or *through* one of the statutes' protected entities.

On appeal, the Seventh Circuit reversed, finding that Section 546(e) does not provide a safe harbor against avoidance of transfers between non-protected entities where a protected entity, such as a financial institution, merely serves as a conduit.[4] Rather, the safe harbor applies only to transfers where a protected entity has a beneficial interest in the underlying transaction.

**The Merit Management Decision & Its Implications**

In *Merit Management*, the Supreme Court affirmed the Seventh Circuit and overruled the prior "majority rule" from other circuits that the safe harbor protection is triggered when the financial institution is a conduit — including the Second and Third Circuits. Although much of the argument presented in *Merit Management* relating to the scope of Section 546(e) involved the interpretation of the statutory language "by or to (or for the benefit of)," the Court stated that debate put the "proverbial cart before the horse." The Court found, instead, that the first step in the analysis requires the identification of the relevant transfer. The Court, citing to the language of Section 546(e) and its broader statutory structure, held that the relevant transfer for purposes of the statutory safe harbor is the overarching transfer that the trustee seeks to avoid, rather than the various intermediate subparts that may have involved a "financial institution" as a conduit.

Although the $16.5 million transfer from Valley View to Merit at issue changed hands from Valley View to Credit Suisse to Citizens Bank and then to Merit, the Court ignored the interim transactions in the transfer chain. Accordingly, the Court concluded that the overarching transfer from Valley View to Merit was not made "by or to (or for the benefit of)" a financial institution and, thus, not protected by the statutory safe harbor of Section 546(e).

The decision has implications for bankruptcy-related litigation involving fraudulent transfers. In particular, the decision strikes down precedent applying the safe harbor protections to transfers where financial institutions were only a conduit — which had been the prevailing view in both the Second and Third Circuits. Because these jurisdictions are home to many of the largest commercial bankruptcies in the United States, the impact of the Supreme Court's decision will clearly be felt in these "high volume" bankruptcy venues.



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[1] *Merit Management Grp., LP v. FTI Consulting, Inc.*, No 16-784, slip op. (Feb. 27, 2018).
[2] Section 546(e) exempts certain pre-petition securities-related transfers from the trustee's avoidance powers if the transfer was "made by or to (or for the benefit of)" a financial institution or another protected entity.
[3] *See, e.g., In re Quebecor World (USA) Inc.*, 719 F. 3d 94 (2d Cir. 2013).
[4] *FTI Consulting, Inc. v. Merit Mgmt. Grp. LP*, 830 F.3d 690,691 (7th Cir. 2016) (holding that "the section 546(e) safe harbor [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 not the transferee but only the conduit").