Bankruptcy Code's Safe Harbor Defense Eliminated by Supreme Court; Variant Defense May Survive

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In a unanimous decision in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc*., the U.S. Supreme Court addressed the scope of a Bankruptcy Code exception to the "avoiding powers" of a bankruptcy trustee or Chapter 11 debtor-in-possession that permit invalidation (*i.e.*, avoidance and clawback) of a limited category of transfers of property by a debtor or of a debtor's interest in property. The Court held that, in circumstances where a voidable debtor transfer of property to a third party involves intermediate transfers, the Bankruptcy Code's Section 546(e) securities safe harbor exception "dictates that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid." Thus, when determining whether an "overarching transfer" (*e.g.*, from A to D) meets Section 546(e) safe harbor criteria, courts should not look to "component parts" (*e.g.*, intermediate transfers from A to B to C to D) of the challenged transfer.

The Court's February 27, 2018, holding spells the end of traditional so-called "conduit defenses" whereby defendants invoke the Section 546(e) safe harbor rule to immunize an overarching transfer from attack, by showing that transfers along the way passed through a "financial institution," such as a bank that is covered by the safe harbor statute. In *Merit*, the Court rejected the defense and its interpretation of the safe harbor. However, the Court reserved judgment on the viability of a possible variant safe harbor defense that might apply when a defendant alleges it was the "customer" of a "financial institution" that acted as a financial intermediary in connection with a challenged "securities contract" transaction.

Background

The transaction at issue was a private cash-for-stock acquisition involving two financial intermediaries. Valley View Downs (debtor-stock buyer) arranged for Credit Suisse (bank lender) to finance Valley's acquisition of the stock of Bedford Downs (target). Credit Suisse wired cash to Citizens Bank of Pennsylvania, which acted as an escrow agent for both Valley and the selling Bedford shareholders. The selling shareholders, including Merit Management, deposited their stock with Citizens Bank in exchange for their share of the $55 million purchase price. Eventually, Valley filed for bankruptcy and the litigation trustee appointed under the Chapter 11 plan commenced a constructive fraudulent transfer action against Merit to avoid and recover the $16.5 million payment that Valley had paid Merit in the cash-for-stock transaction.

Merit moved for judgment on the pleadings, asserting a Section 546(e) securities transaction safe harbor "conduit defense" against the claims. Merit asserted that the safe harbor applied because the $16.5 million payment was a "settlement payment ... made by or to (or for the benefit of)" a financial institution given that the payment was made by and through banks (Credit Suisse and Citizens Bank). The district court granted Merit's motion for judgment on the pleadings, reasoning that the Section 546(e) safe harbor against avoidance applied because such financial institutions had transferred or received funds in connection with a covered "settlement payment" or "securities contract." On appeal, the U.S. Court of Appeals for the Seventh Circuit reversed, holding that the safe harbor rule did not protect transfers in which financial institutions served as mere conduits.

Supreme Court Decision

The Supreme Court affirmed the Seventh Circuit decision, holding that the only relevant transfer for purposes of Section 546(e) safe harbor analysis is the transfer the litigation trustee sought to avoid and recover — that is, the $16.5 million transfer from Valley

View to Merit, not the intermediate transfers to and through Credit Suisse and Citizens Bank. Relying on the plain meaning of the language used in the Bankruptcy Code, the Court said the safe harbor statute "protects only certain transactions 'made by or to (or for the benefit of)' certain covered entities. See 546(e). Transfers 'through' a covered entity ... appear nowhere in the statute." In short, after *Merit*, there is no longer a safe harbor "conduit defense" based merely on the fact that transferred monies passed through a financial institution on their way to the ultimate beneficiary.

Possible Variant Defense

Despite *Merit*'s apparent evisceration of traditional conduit defenses, a footnote in the Court's opinion left open the possibility that an avoidance action defendant like Merit could still rely on the Bankruptcy Code's definition of "financial institution" for a successful Section 546(e) securities safe harbor defense. The Bankruptcy Code defines "financial institution" to include its "customer" when the financial institution is "acting as agent or custodian ... in connection with a securities contract." In *Merit*, the Court did not address the impact Merit's status as a possible customer of Citizens Bank would have had on the Court's application of the safe harbor rule. If, as a customer of a financial institution, Merit had alleged it was a "financial institution" within the meaning of the Bankruptcy Code, Merit might have had a cognizable safe harbor defense to the fraudulent transfer claim. Indeed, during oral argument, Justice Stephen G. Breyer suggested that the case would not have been before the Court if Merit had argued below that either it or the debtor qualified as a financial institution.

Takeaways

The Court's opinion in *Merit* clearly eliminates the viability of a traditional securities safe harbor "conduit defense." However, we expect that *Merit* will give rise to post-*Merit* avoidance litigations that focus on the Bankruptcy Code's definition of "financial institution." That definition may benefit some avoidance action defendants in circumstances similar to those presented in *Merit*. The Court's ruling and its heavy reliance on the "plain meaning" of the Bankruptcy Code suggest that the Code's definition of "financial institution" may be dispositive in post-*Merit* litigations where a fraudulent transfer defendant (or debtor transferor) is alleged to have been a "customer" of a "financial institution" that served as an intermediary or agent in connection with a challenged "securities contract" transaction.

If such a defendant or the debtor itself is deemed to be a "financial institution" for purposes of the Section 546(e) securities safe harbor criteria, the defendant might have a good safe harbor defense. The potential availability of that defense may temper the impact of *Merit* on leveraged buyouts and other transactions that rely heavily on the Section 546(e) securities safe harbor.

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