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SUPREME COURT CURTAILS SHARPLY THE USE OF THE SAFE HARBOR DEFENSE

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I. Introduction

The Supreme Court in *Merit Management Group, LP v. FTI Consulting Inc.*[2], recently ruled unanimously that the safe harbor defense contained in Section 546(e) of the Bankruptcy Code[3] did not protect a shareholder who was sued for a fraudulent conveyance where the stock of a company was purchased by the debtor as part of an acquisition, which was financed by a bank loan and the proceeds of the loan were paid to the target's shareholders through two intermediary financial institutions. In sharply limiting the scope of the safe harbor, the Court held that in determining whether the safe harbor applies to a constructive fraudulent conveyance claim, one must look only at the transfer the trustee is seeking to avoid – in this case, two payments totaling $16.5 million the debtor made to shareholder Merit Management Group, LP ("Merit"); the fact that the payments passed through two financial institutions to reach to Merit was determined to be irrelevant.

The Court's decision also is significant because it goes against the majority of the courts of appeals for the Second, Third, Sixth, Eighth and Tenth Circuits, which held that the safe harbor was applicable even where the covered entity was an intermediary financial institution that served as a mere conduit.[4]

By looking at the substance of the transaction as one from the debtor to the shareholder and ignoring the transfers from the financial intermediaries, the safe harbor defense will no longer be available to shareholders whose stock is acquired as part of a leveraged buyout.

II. Facts

Merit was a shareholder in Bedford Downs Management Corp ("Bedford Downs"), which wanted to engage in harness racing in Pennsylvania. But to do so, a harness-racing license was required from the state. Valley View Downs, L.P. ("Valley View") was a competitor of Bedford Downs and both sought to obtain the last available harness-racing license to operate a "racino." However, neither party could obtain the racing license. To resolve their fight over the last remaining license, the parties agreed that Bedford Downs would withdraw its application for the license and Valley View would purchase all of the Bedford Downs stock for $55 million in cash after Valley View obtained the license. After Valley View obtained the license, it arranged for a $55 million loan to finance the stock acquisition of Bedford Downs as part of a larger $850 million transaction. The transaction was structured so that the lender, Credit Suisse, wired $55 million to Citizens Bank of Pennsylvania, which served as escrow agent for the deal. Both the cash and

the stock certificates of the Bedford Downs shareholders were placed in escrow with Citizens Bank. At closing, Valley View received all of the stock of Bedford Downs and subsequently Citizens Bank made two disbursements totaling $55 million to the shareholders of Bedford Downs, including $16.5 million to Merit.[5]

While Valley View was able to secure the last harness-racing license from the state, it was not able to secure a gaming license for the operation of slot machines for its racino within the timeframe required by its financing. Consequently, Valley View and its parent were forced to file for chapter 11 relief. After a plan was confirmed, the liquidating trustee appointed under the plan sued Merit to claw back the $16.5 million distribution it received as part of the leveraged buyout as a constructive fraudulent conveyance,[6] because the payment was made when Valley View was insolvent and Valley View alleged that it overpaid substantially for the Bedford Downs stock. Merit moved for judgment on the pleadings, claiming that the safe harbor protected the stock buyout "because the transfer was a settlement payment … made by or to (or for the benefit of) a covered financial institution – here, Credit Suisse and Citizens Bank."[7] The district court agreed. The Seventh Circuit reversed, holding that the safe harbor provision in Section 546(e) did not insulate the transfers made by financial institutions that had no beneficial interest in the transfer and served only as conduits for the payment to Merit.[8]

III. The Decision

The issue stated by the Court was whether courts should "look to the transfer that the trustee seeks to avoid" (here, the overarching payment from the debtor to Merit) or whether courts should "look also to any of the component parts to the overarching transfer" (in this case, the transfers from Credit Suisse to Citizens Bank, as escrow agent, and from Citizens Bank to Merit).[9] The Court concluded that the "plain meaning of §546(e) dictates that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid."[10] In reaching this conclusion, the Court reasoned that because the safe harbor is an exception to the trustee's substantive avoiding powers, which are stated in the very first clause of §546(e), one must first start with the transfer the trustee seeks to avoid.[11] Likewise, because the end of Section 546(e) contains another exception, which prohibits the use of the safe harbor for intentional fraudulent conveyances, the Court explained that "Congress signaled that the exception applies to the overarching transfer that the trustee seeks to avoid, not any component part of that transfer."[12] In rejecting Merit's arguments that one should take into account the component intermediary transfers, the Court emphasized that there is no specific language in the safe harbor provision that covers intermediaries. The Court stated:

> The transfer that the trustee may not avoid is specified to be a transfer that is either a settlement payment or made in connection with a securities contract…. Not a transfer that involves. Not a transfer that comprises. But a transfer that is a securities transaction covered under 546(e). . . . In other words, to qualify for protection under the securities safe harbor, §546(e) provides that the otherwise avoidable transfer itself be a transfer that meets the safe-harbor criteria.[13]

Thus, by focusing on the overarching transfer the trustee seeks to avoid[14] – Valley View's $16.5 million payment to Merit for the Bedford Downs stock – the Court looked at the substance of the transaction and held that the intermediate transfers by the two

financial institutions – Credit Suisse and Citizens Bank – were irrelevant in determining whether the safe harbor applied.[15] Because Merit never contended that it was a covered party entitled to protection under §546(e), *i.e.*, a commodities broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency, the safe harbor did not protect the transfer the trustee sought to avoid.[16]

IV. Conclusion

The Court's decision is broad and will make it easier for trustee's to pursue shareholders who were cashed out in a leveraged buyout. By holding that the only relevant transfer is the transfer the trustee seeks to avoid and that the component parts of a buyout transaction are irrelevant, the Court has eliminated the use of the safe harbor defense in leveraged-buyout transactions, where many financial intermediaries touch the funds that are ultimately paid to the target company's shareholders. No longer will the use of a financial institution as a paying agent or escrow agent work to apply the safe harbor. And the five circuit court decisions that applied the safe harbor as long as the funds passed through a financial intermediary are now abrogated. Bankruptcy and liquidating trustees are jumping for joy.

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[2] 138 S. Ct. 883 (2018).

[3] Section 546(e) of the Bankruptcy Code provides in relevant part that the following transfers are immune from avoidance: "a transfer that is a ... settlement payment ... made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract…." 11U.S.C. §546(e).

[4] 138 S. Ct. at 892 n. 6.

[5] *Id*. at 891.

[6] Under 11 U.S.C. §548(b)(1)(B), a transfer may be avoided by a trustee if the debtor received less than reasonably equivalent value for the transfer and the debtor was insolvent or rendered insolent as a result of the transfer.

[7] 138 S. Ct. at 891-92 (quotations omitted).

[8] *Id.* at 892.

[9] *Id.* at 888.

[10] *Id.*

[11] *Id.* at 893.

[12] *Id.*

[13] *Id.* at 894 (quotations omitted).

[14] While the transfer identified by the trustee to be avoided is the starting point in determining whether the safe harbor applies to bar recovery, the Court cautioned that "the trustee is not free to define the transfer that it seeks to avoid in any way it chooses." *Id.*

[15] *Id.* at 895.

[16] *Id.* at 897.