Something Amazing – A Unanimous Opinion by the United States Supreme Court in a Bankruptcy Case, Affirming and Remanding to the Seventh Circuit Regarding the Safe Harbor of 11 U.S.C. § 546(e): Merit Management Group, LP v. FTI Consulting, Inc.

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Once in a while, a Supreme Court opinion crosses my desk that I cannot ignore. Such was the case today. The United States Supreme Court issued its opinion in *MERIT MANAGEMENT GROUP, LP v. FTI CONSULTING, INC*., a unanimous opinion made more exciting by the fact that it affirmed the Seventh Circuit's decision regarding the scope of the safe harbor provisions of 11 U.S.C. § 546(e) in a case that arose from a failed harness racing endeavor. Perhaps even more surprising, the Court interpreted a section of the Bankruptcy Code that led to a split in the circuits using a "plain meaning" approach.

We all know that trustees in bankruptcy can exercise "avoiding" powers in their efforts to equalize treatment and maximize funds available for distribution to creditors. In essence, a trustee can undo certain transactions and transfers that took place before the bankruptcy was filed. But we also know that there are exceptions to those avoiding powers. An exception protects the transfer from avoidance and leaves the parties to the transaction in the same position they were in before the bankruptcy. Creditors do not benefit from a trustee's efforts when an exception applies.

One frequently claimed exception to certain securities transfers is known as the "safe harbor" exception. Section 546(e) of the Bankruptcy Code provides that a trustee cannot avoid a transfer of "settlement payment" made by or to (or for the benefit of) certain financial institutions or that is a transfer made by or to (or for the benefit of) certain financial institutions "in connection with a securities contract." A split in the circuits existed as some courts (the Second, Third, Sixth, Eighth, and Tenth Circuits) had decided that the securities safe harbor applied to transactions facilitated by financial institutions even when serving only as an intermediary or conduit whereas other courts (the Seventh and Eleventh Circuits) ruled the other way and refused to apply the safe harbor provisions to those situations. In this case, one party (Valley View) obtained the last harness racing license in Pennsylvania but never opened for business as it was not able to obtain slot-machine licenses in the time required by its financing package.

Valley View and Centaur, its parent, filed bankruptcy. After a plan was confirmed, FTI was appointed trustee of the Centaur litigation trust. Litigation ensued in FTI's effort to set aside the ultimate transfer at issue (payment for stock), which occurred in several steps with various financial institutions involved in the sequence. The Supreme Court explained the substance of the transactions thus:

On one side, Merit [a seller of stock to Valley View] posits that the Court should look not only to the Valley View-to-Merit end-to-end transfer, but also to all its component parts. Here, those component parts include one transaction by Credit Suisse to Citizens Bank (*i.e.,* the transmission of the $16.5 million from Credit Suisse to escrow at Citizens Bank), and two transactions by Citizens Bank to Merit (*i.e.,* the transmission of $16.5 million over two installments by Citizens Bank as escrow agent to Merit). Because those component parts include transactions by and to financial institutions, Merit contends that §546(e) bars avoidance.

FTI, by contrast, maintains that the only relevant transfer for purposes of the §546(e) safe-harbor inquiry is the overarching transfer between Valley View and Merit of $16.5 million for purchase of the stock, which is the transfer that

the trustee seeks to avoid under §548(a)(1)(B).Because that transfer was not made by, to, or for the benefit of a financial institution, FTI contends that the safe harbor has no application.

MERIT MANAGEMENT GROUP, LP v. FTI CONSULTING, INC., typescript, p. 10.

In the initial litigation, the District Court agreed with Merit and applied the safe harbor. On appeal, that ruling was reversed by the Seventh Circuit. The U.S. Supreme Court accepted c*ertiorari* to resolve the split in the circuits.

After reviewing the history of bankruptcy avoidance powers and the safe harbor exception, the Supreme Court reverted to the "plain meaning" construct and ruled that section 546(e) is clear; there is only one transfer at issue. The relevant transfer is the overarching one the trustee wants to avoid under an applicable avoidance power, regardless of how many component parts take place prior to the ultimate termination of the transaction. Unless the transaction was "by, to or for the benefit of" a financial institution, the safe harbor exception does not apply. The Court specified that section 546(e) encompasses only those transfers by, to or for the benefit of a financial institution –"Not a transfer that involves. Not a transfer that comprises. But a transfer that is a securities transaction covered under §546(e)." *MERIT MANAGEMENT GROUP, LP v. FTI CONSULTING, INC*., typescript, p. 13.

Although the opinion leaves open other questions and does not clarify every type of transfer in which a financial institution is involved, as a result of the Supreme Court's ruling, relying on a plain meaning textual analysis, we now have a bright line test to apply. Where the financial institution did nothing more than act as a conduit to facilitate a transaction for other parties, the safe harbor does not apply to protect the ultimate transferee and the transaction can be avoided if the trustee satisfies the terms of the underlying avoidance provision.

A copy of the opinion can be accessed here:

https://bkinformation.com/newcases/casecopies/Merit-2-28-2018.pdf

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