Bankruptcy & Financial Restructuring ADVISORY ■

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Payments to a REMIC Trust Find Safe Harbor, But Another Storm Is Brewing…

The Bankruptcy Court for the Northern District of Illinois issued a noteworthy opinion for those whose work involves real estate mortgage investment conduit trusts (REMIC trusts) or utilization of the Bankruptcy Code's "safe harbor" provisions. In *In re MCK Millennium Ctr. Parking, LLC,*[1] Bankruptcy Judge Jacqueline P. Cox addressed whether payments made on loans that have been securitized are protected by the safe harbor provisions of Section 546(e) of the Bankruptcy Code; where the safe harbor doesn't apply, a trustee may be able to claw back such payments under the avoidance provisions of the Bankruptcy Code (*See e.g.*, 11 U.S.C. §§ 547 and 548.). In so doing, the court dissected the structure of, and payment fund flow related to, a loan in a REMIC trust and then applied the language of Section 546(e). The court held that such payments are largely protected by Section 546(e) and the trustee was not permitted to claw them back.

Background

Before the debtor filed for bankruptcy, its affiliated company, Millennium Centre Retail, LLC ("Retail") borrowed $11.2 million. The Retail loan was then transferred into a REMIC trust as part of a securitization pursuant to a pooling and servicing agreement (PSA). Thus, the trustee of the REMIC trust held title to the Retail loan (and the other pooled loans) for the benefit of the certificate holders in the REMIC trust.

Prepetition, the debtor made payments on the Retail loan. The defendant claimed that the payments were made to a bank that was the master servicer of the REMIC trust. Thereafter, the master servicer would transfer the payments to the REMIC trustee, which would in turn distribute returns to investors in the REMIC trust.

The trustee of the debtor's bankruptcy estate asserted that he could avoid (or "claw back") the debtor's payments on the Retail loan because those payments only benefited Retail, and did not benefit the debtor. (*See e.g.*, 11 U.S.C. §§ 548(a), 550.) In response, the defendants maintained, among other arguments, that the payments were protected from avoidance under the safe harbor of Section 546 of the Bankruptcy Code.

Analysis

Each element of Section 546(e)'s safe harbor must be satisfied in order to prevent the trustee from avoiding an otherwise avoidable transfer: (1) the transfers are made by or to a financial institution; and (2) the transfers are made in connection with a securities contract.

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1 AP No. 14-00392, 2015 WL 1951036 (Bankr. N.D. Ill. Apr. 30, 2015).

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The court found the first element was satisfied. The debtor made the payments to the master servicer, and the defendants had claimed that the master servicer was a commercial bank. The trustee acknowledged that the commercial bank was a "financial institution," but argued that the bank acted as a mere conduit (i.e., the bank did not receive any benefit or acquire the funds for its own use) and therefore should not satisfy the statute's required element. The court reviewed a split of authority on this issue and decided that the plain text of the statute requires the transfer to be *to* a financial institution. There is no requirement in the statute that the financial institution be the beneficial recipient of the money or that the financial institution use the money. Thus, the court declined to read such a requirement into the statute.

The court also found the second element was satisfied. The court first examined whether the PSA, which governs the terms of the REMIC trust, was a securities contract. The court found that the definition of "securities contract" is intentionally broad. "The term 'securities contract' expansively includes contracts for the purchase or sale of securities, *as well as any agreements that are similar or related to* contracts for the purchase or sale of securities." (quoting *In re Madoff Inv. Sec., LLC, 773* F.3d at 418) (emphasis added). Here, the court found, the PSA outlined a securitization plan whereby principal and interest payments flow to certificate holders of the REMIC trust. The trustee argued that the transfers were payments made on account of the *Retail loan* and not the PSA—thus the focus must be on whether the *Retail loan* was a securities contract (which, the trustee argued, it was not). The court disagreed, finding that the text of the statute is worded intentionally broadly to encompass the transfers in question. "[H]ere the ... transaction involved the transfer of the Retail Loan into the [REMIC] Trust and the subsequent issuance of certificates representing investors' interests in the bundled loans. The Court rejects the [trustee's] novel proposition that any two-tiered transaction precludes a finding that a securities contract is involved. Nothing in the statute or case law cited by the [trustee] mandates such a result. The transactions in this case fit squarely within the definition of a securities contract…" (citations omitted).

Next, the court found that the transfers were made *in connection with* a securities contract. Although the trustee argued that the payments were made on account of the Retail loan and not on account of the PSA, the court found that the phrase "in connection with" is broad enough to encompass the payments. "In this case, the loan payments were related to a security agreement. The payments were maintained in a Distribution Account maintained by the Trust, and distributed to certificate holders based upon a distribution program set forth in the PSA. The way the payments were to be maintained, held, and distributed was included in the PSA. While the payments were not necessarily made for the purchase or sale of securities, the payments were made in relation to a security agreement, the PSA, and therefore fall within the safe harbor provision of § 546(e)." Thus, the court found that the two-tier structure of the REMIC trust did not preclude a payment made on one of the bundled loans to be protected from avoidance by the safe harbor provision of Section 546(e).

Takeaway

The *MCK Millenium* case appears to be one of the first to specifically address whether payments made on loans that are pooled in commercial mortgage-backed security (CMBS) structures are entitled to the safe harbor protections of Section 546(e). If followed by other courts, this holding will provide greater certainty to investors in securitized vehicles that their investments will not be greatly upset by bankruptcies, whether the bankruptcy is by the borrower on the loan that is owned by the trust or by a non-borrower entity that made payments on the loan.

More to Come …?

After the bankruptcy court issued its findings, the trustee filed a notice of appeal of the bankruptcy court's order. Shortly after, the defendants filed a statement before the bankruptcy court in which they disclosed that certain factual statements that they had made, which were relied upon by the court in its ruling, were incorrect. Specifically, the defendants' corrected statement stated that the master servicer was not a bank or a "financial institution"—the master servicer was a separate legal entity that was an affiliate of the commercial bank originally identified as the master servicer. In light of these new facts, the trustee has asserted that Section 546(e)'s safe harbor is not applicable because it requires that a transfer be both to a financial institution and made in connection with a securities contract. In light of this new information, the trustee sought and obtained a stay of its appeal so that the bankruptcy court could reconsider its ruling. Under the current schedule, the court will hold a hearing on September 10, 2015. At or following that hearing, the bankruptcy court will likely issue a new opinion confirming or revising its prior holding. Updates will be provided as they develop.

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Kit Weitnauer
404.881.7780
kit.weitnauer@alston.com

David Wender
404.881.7354
david.wender@alston.com

Suzanne Boyd
404.881.7415
suzanne.boyd@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ■ Fifth Floor ■ East Palo Alto, CA 94303-2282 ■ 650.838.2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.756.3300 ■ Fax: 202.756.3333