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U.S. Supreme Court Narrows the Scope of the Section 546(e) Safe Harbor

On February 27, 2018, the U.S. Supreme Court resolved a circuit court split over the proper application of the securities contract "safe harbor" provision found in Section 546(e) of the Bankruptcy Code.

Section 546(e) provides an exception to a bankruptcy trustee's ability to avoid or claw back certain transfers of a debtor's property. Under Section 546(e), "settlement payments," "margin payments," and other transfers "made by or to (or for the benefit of)" financial institutions, financial participants, and other counterparties cannot be avoided. A split evolved between certain circuit courts about whether the Section 546(e) securities contract safe harbor applies to settlement payments when the settlement payments merely passed through a financial institution as a conduit or intermediary.

In *Merit Management Group LP v. FTI Consulting Inc*., the Court resolved this circuit split, holding that in applying the Section 546(e) safe harbor, courts are to concern themselves with the "overarching transfer that the trustee seeks to avoid under one of the substantive avoidance provisions." The Court explained that "if a trustee properly identifies an avoidable transfer … the court has no reason to examine the relevance of component parts when considering a limit to the avoiding power, where that limit is defined by reference to an otherwise avoidable transfer, as is the case with [Section] 546(e)."

The Supreme Court's decision in *FTI Consulting* effectively narrowed the scope of Section 546(e) to exclude protection for transferees who are not otherwise financial institutions or other protected intermediaries when a settlement payment or transfer merely passes through a financial institution or other intermediary.

FTI Consulting was serving as trustee of a liquidation trust in connection with a Chapter 11 case and sought to avoid a constructively fraudulent transfer and recover a portion of money paid by the debtor, Valley View, to purchase a Pennsylvania racetrack and casino operator. Specifically, FTI sought clawback of $16.5 million paid by Valley View to Merit Management Group (MMG) for its interest in an overall $55 million transaction. The transfer challenged in *FTI Consulting* passed through financial institution intermediaries before ultimately winding up in the hands of MMG.

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MMG argued that the safe harbor protection of Section 546(e) applied to transfers where financial institutions serve as intermediaries, not just in cases where the institution directly benefits from the transfer. In *FTI Consulting*, Valley View purchased the entirety of Bedford Downs stock. Valley View financed the purchase through a bank and other lenders, which included a bank serving as an escrow agent that ultimately distributed the $16.5 million to MMG. Because the purchase included transactions through financial intermediaries, MMG argued that the transaction could not be avoided because it qualified for the safe harbor of Section 546(e).

The Court reasoned that Section 546(e) clearly operates as an exception to a trustee's avoiding powers and draws a "connection between the transfer that the trustee seeks to avoid and the transfer that is exempted from that avoiding power pursuant to the safe harbor." The Court then meticulously observed that the language of Section 546(e) states that the transfer that may not be avoided is "specified to be 'a transfer that *is*' either a 'settlement payment' or made 'in connection with a securities contract'" and "[n]ot a transfer that involves" or "comprises" (emphasis in original).

Therefore, "the provision explicitly equates the transfer that the trustee may otherwise avoid with the transfer that, under the safe harbor, the trustee may not avoid." It is this statutory structure on which the Court based its holding that the transfer that a trustee seeks to avoid is the relevant transfer for consideration of the safe harbor protections.

The *FTI Consulting* decision has significant implications for market participants that are not otherwise financial participants or protected financial institutions, who, pursuant to this decision, may no longer be able to rely on the securities contract safe harbor defense to protect transactions from a trustee's avoidance powers in leveraged buyouts and other securities transactions. In particular, selling stockholders in a leveraged buyout must be wary of a potential clawback of sale proceeds by a bankruptcy trustee or debtor-in-possession, who now may exercise a broader right to unwind transfers that were previously protected under Section 546(e). Going forward, the risks associated with such transactions to participants not otherwise included within the safe harbor must be viewed with *FTI Consulting* in mind.

As a final note, the Court observed that it was not addressing the issue of whether an entity qualifies as a "financial institution" by virtue of its status as a "customer" under Section 101(22)(A).[1] It is likely that future battles over the ramifications of this remaining gray area lie ahead.

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[1] The Bankruptcy Code definition of "financial institution" includes an "entity [that] is acting as agent or custodian for a customer." 11 U.S.C. 101(22)(A).

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