Supreme Court Clarifies Power to Claw Back Transfers Made Through Financial Institutions

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A Feb. 27, 2018, decision by the U.S. Supreme Court resolved a split in the circuit courts by clarifying that a bankruptcy trustee, creditors' committee or other entity with standing may claw back preferences and constructive fraudulent transfers involving the purchase of securities, even though the transaction was effectuated by depositing funds or securities with financial institutions. The Court's decision in *Merit Management Group LP v. FTI Consulting Inc.* [1] held that § 546(e)'s safe-harbor provision requires courts to look to the transaction being challenged and determine whether the defendant in the avoidance action — the ultimate recipient of the funds — is a "covered" entity under the statute. The analysis does not focus on the constituent components of the transaction that may involve financial institutions.

Section 546(e)'s Safe Harbor

The Bankruptcy Code allows bankruptcy trustees and their successors to avoid certain pre-petition transfers by a debtor, including preferences [2] and constructive fraudulent conveyances. [3] Section 546(e) provides a safe harbor for certain types of transfers to certain enumerated, "covered" entities. These include transfers that are "settlement payment[s]" "made by or to (or for the benefit of)" a covered entity, such as a "financial institution," or transfers made to a covered entity "in connection with a securities contract." [4] The dispute was whether § 546(e) applied where A purchased securities from D, but the transaction was effectuated by intermediary transactions in which the consideration and securities were deposited in a financial institution. A typical scenario involves securities transactions where a financial institution acting as agent receives and distributes the purchase price and securities.

Prior Interpretations of § 546(e)

Prior to the *Merit Management* decision, most circuit courts interpreted § 546(e) broadly. [5] Although the plaintiff in the avoidance actions sought to claw back funds from the actual counterparty to the overall securities transaction, these courts analyzed a transaction's component parts in which cash or securities were first deposited with a bank acting as agent. [6] These courts focused on § 546(e)'s use of the phrase "by or to (or for the benefit of) a ... financial institution" and held that § 546(e) applied to protect any transaction in which funds or securities passed through a financial institution. One district court interpreted § 546(e) to apply where the buyer simply wired funds for a stock purchase from its bank account — admittedly held at a "financial institution" — to the seller's bank account — also held at a "financial institution." [7] Under this analysis, § 546(e) would immunize almost any securities transaction.

FTI Consulting Inc. v. Merit Management

Until 2016, the Eleventh Circuit was the only circuit court that took a narrower view of § 546(e). [8] In 2016, the Seventh Circuit added its voice, holding that § 546(e) applied only where the ultimate "transferee" was a covered entity, without regard to the financial intermediaries. [9] The court concluded, "We will not interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." [10]

In *FTI Consulting Inc. v. Merit Mgmt. Grp LP*, the court examined a leveraged buyout in which the debtor/purchaser first wired funds from its bank to another bank, acting as escrow agent, and the sellers deposited securities with the escrow agent. [11] The purchaser subsequently filed for bankruptcy and sought to unwind the LBO. [12] Defendants argued that the involvement of banks wiring funds or acting as escrow agents constituted protected transactions "made by or to" a financial institution, thereby immunizing the actual securities transaction between the nonfinancial institution counterparties. [13]

The Seventh Circuit rejected this argument. It held that "the economic substance" of the transaction is of primary importance, [14] and it rejected the notion that § 546(e) "covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." [15] Such an interpretation "would be so broad as to render any transfer nonavoidable unless it were done in cold hard cash...." [16] Section 546(e) applied "where the [covered] entity is a counterparty as opposed to a conduit or bank for a counterparty." [17]

The Supreme Court Decision

The Supreme Court granted *certiorari* and affirmed the Seventh Circuit. [18] The Court held that the "relevant transfer" for purposes of § 546(e) was the transaction that the trustee sought to avoid. [19] The intermediate, component or conduit transfers are not factors in determining § 546(e) safe-harbor applicability. [20] Applying its holding to the facts of the case, the Court noted that the trustee sought to avoid "the purchase of ... stock by [the debtor] from Merit...." [21] Neither of those parties were covered entities under § 546(e), therefore the safe harbor did not apply. The "component parts [of the transaction] are simply irrelevant to the analysis under § 564(e)." [22]

The Court rejected Merit's argument that its holding could have an unintended effect on certain market participants, such as a securities clearing broker. [23] If a trustee sought to avoid the transfer to the clearing broker itself, then § 546(e) would provide a safe harbor. [24]

The Effect of the Decision

The Court's decision strengthens trustees' powers to bring money into an estate by confirming that securities transactions between noncovered parties are subject to avoidance, even if the transaction is effectuated through financial institutions. The decision concurrently affirms tl safe harbor protects financial institutions acting as intermediaries, ensuring that a trustee must seek to recover funds from the actual counterparties in the transaction.

The *Merit Management* decision will likely raise new questions. Although the Court focused on "the transfer the trustee seeks to avoid," it noted that Merit did not question the trustee's decision to challenge the transaction between debtor and Merit, as opposed to the component transactions. [25] Future defendants will no doubt do so, however, so this raises the question of how much flexibility a trustee has to identify the relevant transaction for avoidance. For example, in an IPO where the underwriter initially purchases the shares and resells them to the public, can a trustee reach over the underwriter to claw back the shares from the public purchasers or their transferees? Where a financial institution is trading on its own account and not acting as an "industry hub," [26] is it entitled to the safe harbor? Finally, the Court recognized that a bank's customer can fall within the Code's definition of "financial institution." [27] As a result, it stands to reason that future transactions may be structured in a manner to take advantage of this loophole.

[1] *Merit Management Group LP v. FTI Consulting Inc.*, 583 U.S. ___, 138 S. Ct. 883 (2018).

[2] 11 U.S.C. § 547.

[3] 11 U.S.C. § 548.

[4] 11 U.S.C. § 546(e).

[5] *See Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (In re Quebecor World (USA) Inc.)*, 719 F.3d 94 (2d Cir. 2013); *QSI Holdings Inc. v. Alford (In re QSI Holdings Inc.)*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 983, 987 (8th Cir. 2009); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230 (10th Cir. 2009).

[6] *See*, *e.g.*, *Quebecor World*, 719 F.3d at 100.

[7] *U.S. Bank N.A. v. Verizon Commc'n Inc.*, 892 F. Sup. 2d 805, 814-15 (N.D. Tex. 2012).

[8] *Munford v. Valuation Research Corp. (In re Munford Inc.),* 98 F.3d 604 (11th Cir. 1996).

[9] *FTI Consulting Inc. v. Merit Mgmt. Group LP*, 830 F.3d 690 (7th Cir. 2016).

[10] *Id.* at 697.

[11] *Id.* at 691.

[12] *Id.* at 692.

[13] *Id.* at 693-94.

[14] *Id.* at 695.

[15] *Id.* at 697.

[16] *Id.* at 695.

[17] *Id.*

[18] *Merit Mgmt*., 138 S. Ct. at 898.

[19] *Id.* at 893-95. The analysis is the same whether the transaction was a "settlement payment" or in connection a "securities contract." *Id.* at 892 n.5.

[20] *Id*. at 893. The Court noted that the Bankruptcy Code allows the trustee to recover transferred property from "any immediate or mediate transferee of such initial transferee." *Id.* at 889 (citing 11 U.S.C. § 550(a)).

[21] *Id.* at 895.

[22] *Id.*

[23] *Id.* at 896.

[24] *Id*.

[25] *Id.* at 895.

[26] *Id.* at 897.

[27]*Id.* at 890, n.2.

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