ROPES & GRAY

ALERT

Business Restructuring ▪ Private Equity

February 28, 2018

Supreme Court Narrows Bankruptcy "Safe Harbor" Fraudulent Transfer Protections

Attorneys
Gregg M. Galardi
James M. Wilton
Keith H. Wofford
Stephen Moeller-Sally
William M. Shields
David Blittner

On February 27, 2018, the U.S. Supreme Court issued a ruling that will make it easier for bankruptcy trustees, creditors' committees, and other bankruptcy estate representatives to claw back payments made to shareholders in leveraged buyouts and dividend recapitalizations.

Constructive Fraudulent Transfer Claims and the Securities Safe Harbor

The Bankruptcy Code empowers bankruptcy trustees to avoid certain "constructive fraudulent" transfers made when an insolvent debtor received less than reasonably equivalent value in exchange for transfers of cash or other assets. However, a "securities safe harbor" under Bankruptcy Code section 546(e) shields from avoidance transfers that are settlement payments or related to a securities contract, when "made by or to (or for the benefit of) . . . financial institutions" and other designated participants in the securities markets.

In *Merit Management Group, LP v. FTI Consulting, Inc.* ("*Merit Management*"), the Supreme Court held that the securities safe harbor applies only when defendants are themselves covered entities, i.e., financial institutions or one of the other market participants designated in the statute. Prior to this ruling, a majority of appellate courts, including in the Second and Third Circuits where many complex bankruptcy cases are filed, interpreted this safe harbor to protect any applicable transfer that was made through a covered entity, even if the ultimate recipient was not itself a financial institution or other covered entity.

The *Merit Management* Case

Merit Management arose out of the bankruptcy of a private company, Valley View Downs, LP, which was the owner of a Pennsylvania racetrack. In 2003, Valley View purchased stock of another racetrack, Bedford Downs, for $55 million. Merit Management, a shareholder of Bedford Downs, received $16.5 million in the transaction. The payment was initiated by Credit Suisse, which financed the transaction. The purchase price was initially paid to Citizens Bank, which acted as escrow agent, and Citizens Bank then disbursed the $16.5 million to Merit Management. Valley View filed for bankruptcy protection, and FTI Consulting, acting as trustee for a litigation trust for Valley View's creditors, initiated a constructive fraudulent transfer action to avoid the payment to Merit Management. Merit Management argued, consistent with the majority view of circuit courts of appeal, that the securities safe harbor shielded the payment from avoidance because it was made by and through two financial institutions, Credit Suisse and Citizens Bank. The Seventh Circuit disagreed, holding that the section 546(e) safe harbor did not apply because the financial institution intermediaries had no beneficial ownership of the disputed funds, but served merely as conduits for the transfer.

Supreme Court Decision

The Supreme Court affirmed the Seventh Circuit, holding that Congress intended section 546(e) to apply to the transfer the trustee seeks to avoid, and that courts should ignore the covered status of any intermediary parties to the transfer. Under *Merit Management*, the safe harbor will protect a transfer only if the transferor or the transferee in the transfer to be avoided is itself a financial institution or other covered entity. The Court dismissed policy arguments that a narrowing of the safe harbor will have a disruptive impact on securities markets. Further, the Court failed to draw any distinction between the small, private transaction at issue in *Merit Management* and larger, public company transactions more deeply integrated with the securities clearing system.

Implications

The Supreme Court's decision disrupts a widely recognized interpretation of the Bankruptcy Code that protected many transactions from constructive fraudulent transfer risk. Leveraged buyouts, leveraged recapitalizations, and other transactions effected through financial institutions as intermediaries have often permitted the participants to claim the securities safe harbor protection under the statutory interpretation that the Supreme Court has now rejected.

The Supreme Court's analytical focus on the "transfer the trustee seeks to avoid" will give rise to further litigation regarding the identities of the transferors, intermediaries and transferees in challenged transfers. *Merit Management* does not completely foreclose the possibility of a broader safe harbor for securities transactions. In a footnote, the Supreme Court recognized that the Bankruptcy Code defines "financial institution" expansively to encompass not only entities traditionally perceived as financial institutions, such as banks or trust companies, but also the "customers" of those entities when those entities act as agents or custodians in connection with a securities contract. Merit Management did not argue, as a customer of one of the designated covered entities, that it also qualified as a "financial institution" under the Bankruptcy Code definition. Because that argument was not raised, the Supreme Court declined to address it. While few courts have considered customer status in the context of the section 546(e) safe harbor, we expect that this aspect of the safe harbor defense will draw the attention of defendants in fraudulent transfer litigation in the near future.

For more information regarding this recent decision, or to discuss fraudulent transfer litigation risk generally, please feel free to contact Gregg Galardi, Jim Wilton, Keith Wofford, or Steve Moeller-Sally from our business restructuring group or Will Shields or David Blittner from our private equity transactions group or your usual Ropes & Gray advisor.