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# Mallinckrodt Trust Asserts Novel Argument in Response to Safe Harbor Defense (US)

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A common defense to a fraudulent transfer claim in bankruptcy concerning a securities transaction is the "safe harbor" defense under section 546(e) of the Bankruptcy Code. In a unique twist, a post-confirmation trust in Delaware recently argued that the safe harbor defense should not be available if the underlying transaction was illegal under the law where the debtor/transferor was incorporated. As discussed below, both sides present thoughtful and well-reasoned arguments, and the bankruptcy court is now set to rule on whether a fraudulent transfer complaint should be dismissed for three defendants.

**Background**

On October 12, 2020, global pharmaceutical enterprise Mallinckrodt plc and certain of its related entities ("Mallinckrodt") filed chapter 11 bankruptcy petitions in Delaware in the wake of widespread liabilities associated with its opioid painkillers. On March 2, 2022, the bankruptcy court confirmed Mallinckrodt's plan of reorganization, which, in part, established the Opioid Master Disbursement Trust II (the "Trust") to pursue certain claims and causes of action for the benefit of opioid crisis victims and other Mallinckrodt creditors. In furtherance of recovering assets, on October 12, 2022, the Trust commenced an adversary proceeding to avoid and recover the transfer of close to $1.6 billion that Mallinckrodt paid its shareholders between 2015 and 2018 pursuant to an open market purchase of publicly traded stock from public shareholders (the "Share Repurchases"). Of the dozens of defendants in the adversary proceeding, three were (1) Citadel Securities LLC ("Citadel"), (2) Susquehanna Securities LLC ("Susquehanna"), and (3) T. Rowe Price Associates, Inc. ("TRP," collectively with Citadel and Susquehanna, the "Defendants").

**Trust's Fraudulent Transfer Claims**

The Trust's complaint contained four counts of intentional fraudulent transfer and constructive fraudulent transfer under sections 544(b) and 550(a) of the Bankruptcy Code, sections 428.024 and 428.029 of the Missouri Revised Statute, and section 3304 of Title 28 of the United States Code. In an amended complaint, the Trust further argued that as a company incorporated in Ireland, Mallinckrodt's Share Repurchases were made in violation of Irish law because Mallinckrodt was insolvent at the time of the share repurchases.

**Defendants' Safe Harbor Defense**

In the two motions to dismiss filed by the Defendants on December 8, 2023, the Defendants argued that section 546(e) of the Bankruptcy Code, also known as the safe harbor defense, insulated the Defendants from liability. Specifically, section 546(e) provides that transactions that are "settlement payments," or transfers "in connection with a securities contract," made by or to "financial participants," are not avoidable under section 544 (among other sections). In short, the safe harbor defense has two requirements: (1) a "qualifying transaction" (*i.e.*, a "settlement payment" or "transfer made in connection with a securities contract"), and (2) a "qualifying participant" (*i.e.*, the transfer was made by or to (or for the benefit of), among others, a "financial institution" or "financial participant").

In response to the amended complaint, the Defendants argue that the first prong, a "qualifying transaction," was satisfied because the Share Repurchases were payments to complete the open-market purchase of Mallinckrodt's publicly traded shares (*i.e.*, settlement payment) and/or the Share Repurchases were executed pursuant to a securities purchase agreement and sell orders (*i.e.*, transfer made in connection with a securities contract). In support of satisfying the second prong of the defense, a "qualifying participant," the Defendants cite how they are either one of the largest financial participants (*e.g.*, Citadel undertaking billions of dollars of trades and options) or are otherwise a registered investment company (*e.g.*, TRP).

**Trust's Opposition to Defendants' Motions to Dismiss**

In response, the Trust argues that the Defendants cannot avail themselves of the safe harbor defense for three reasons.

*First*, the Trust alleges that Irish law provides that share repurchases are void when a company does not have profits available for distribution, and therefore the Share Repurchases were *void ab initio* (*i.e.*, void from the beginning) and not a "settlement payment" (*i.e.*, a "qualifying transaction"). Specifically, the Trust argues that the Share Repurchase program was governed by Irish law because the state of incorporation governs affairs involving a corporation and its shareholders (including share repurchases), and since Irish law provides that share repurchases can only occur if the purchases are funded out of "profits available for distribution," Mallinckrodt's failure to account for the "probable" opioid liability under generally accepted accounting principles made the entire Share Repurchase program *void ab initio*. The Trust cited two bankruptcy court opinions from the Second and Ninth Circuit in support of its position that a bankruptcy court cannot apply the safe harbor when the underlying transaction was impermissible under applicable law because the distribution would be considered "a complete nullity."

*Second*, the Trust argues that the Share Repurchases were not made "in connection with a securities contract," and therefore not a "qualifying transaction," because the share repurchase agreement was allegedly void under Irish law. Furthermore, the Trust argues that the Defendants have not provided the Trust with a copy of any agreement, including the share repurchase agreement, whereby Mallinckrodt agreed to directly sell any shares to the Defendants, rather than to brokers.

*Third*, with respect to TRP's motion to dismiss, the Trust argues that TRP is not a "financial institution" (*i.e.*, a "qualifying participant") because the Share Repurchase agreements were void and TRP is not a party to any such agreements and therefore did not have the requisite "connection with a securities contract."

**Defendants' Arguments in Support of the Safe Harbor Defense**

As referenced above, in their motions to dismiss, the Defendants preemptively rebut the Trust's argument that the Share Repurchases were not a "qualifying transaction" because Mallinckrodt was insolvent when the Share Repurchases occurred, and therefore such transfers were void under Irish law. In their reply briefs, the Defendants assert the following additional rebuttals to the Trust's arguments:

- The two out-of-circuit cases relied on by the Trust are inconsistent with Third Circuit precedent because the Third Circuit defines a "settlement payment" as a transfer of cash or securities made to complete a securities transaction, and it is irrelevant whether the transfer was void, illegal, or inconsistent with the law of the debtor's place of incorporation.
- The same two out-of-circuit cases are furthermore inconsistent with subsequent decisions in the circuits in which those cases were decided because these circuits only require that a payment was made to complete a securities transaction and that the legality or voidability of the transaction did not matter, *e.g.*, in the Bernie Madoff Ponzi scheme cases before the Second Circuit, the safe harbor defense still applied.
- The Trust's argument is inconsistent with the Bankruptcy Code because fraudulent transfers often occur when a company is insolvent (*e.g.*, constructive fraudulent transfers require proving that a debtor was insolvent or became insolvent after the transfer) and the safe harbor defense was intended to prevent the avoidance of security transfers in precisely this context.
- Congress' intent in enacting the safe harbor was to minimize instability and displacement in the securities market, not to require a complex inquiry into the facts and legality of transfers under the local law of the debtor's place of incorporation.
- Nothing in the text of section 546(e) suggests that state or foreign law is relevant, let alone determinative.
- The Share Repurchases were made "in connection with a securities contract" because Mallinckrodt hired brokers to act as its agent to repurchase its shares in the open market, which courts have repeatedly held qualify as payments "in connection with" a securities contract even though the shareholders themselves were not parties to the repurchase agreement.

As of the filing of this post, the bankruptcy court has not yet ruled on the Defendants' motions to dismiss.

**Takeaways**

Putting aside the "qualifying participant" arguments, the parties' arguments related to whether the Share Repurchases are a "qualifying transaction" are complex and unique. The Trust relies on Irish law to argue that the Share Repurchases should be disregarded as illegal transfers, and therefore not eligible for the safe harbor defense. The argument is that there can be no "settlement payment" or transfer "in connection with a securities contract" if the payment transactions are void.

On the other hand, the Defendants argue that the two primary cases the Trust cited are inconsistent with Third Circuit precedent or more recent opinions in the Second and Ninth Circuit, and that when deciding if a transaction is a "settlement payment," courts only consider whether there was a transfer of cash or securities to complete a securities transaction and will not investigate the legality of the underlying transaction. The Defendants also appeal to the practical realities of the safe harbor defense by asserting that such defense is almost always used when the debtor was insolvent at the

time of the suspect transaction, or shortly thereafter. According to the Defendants, under the Trust's logic, the safe harbor defense would almost never be available to fraudulent transfer defendants.

The bankruptcy court certainly faces a difficult challenge in deciding whether the Trust alleged facts sufficient to support a reasonable inference that the Share Repurchases were void under Irish law, and that therefore the 546(e) safe harbor defense is unavailable to the Defendants. To avoid the litigation plaguing the Defendants, parties to future security transactions should consider the following issues stemming from the *Mallinckrodt* adversary proceeding:

- Is the security issuer facing significant contingent and/or unliquidated liabilities that may eventually result in the need to file for bankruptcy protection, thus subjecting the counterparty to a potential fraudulent transfer claim?
- Is the security issuer's proposed security transaction lawful under the law in which the issuer is incorporated, *i.e.*, can the counterparty utilize the safe harbor defense by negating an argument that the transfer was *void ab initio* as an unlawful transaction and therefore not a "settlement payment"/"qualifying transaction"?
- If faced with a fraudulent transfer claim, is the counterparty, and not just the counterparty's broker, listed in the applicable security contract (*e.g.*, share repurchase agreement, purchase order)? If so, this would bolster the safe harbor defense argument that the security transaction was made "in connection with a securities contract" and therefore a "qualifying transaction."



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