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Financial Regulation: Narrowing Channel into Section 546(e)’s Safe Harbor?

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The *Seventh Circuit* has significantly restricted the application of Section 546(e)’s safe harbor from the avoidance of settlement payments where a financial institution merely served as a conduit for payment.[1] The court reopened a circuit split when it asked the rhetorical question: When you receive a letter from a friend through the mail, do you ordinarily say that the letter was sent by the *friend* or the *post office*?

Merit arose from the merger of Valley View Downs, a Pennsylvania racetrack, with Bedford Downs in an all stock leveraged buyout (LBO) transaction. Valley View Downs filed a chapter 11 bankruptcy shortly after closing when it failed to acquire the gambling license. The liquidation trustee sued the principal selling shareholder, Merit Management Group, to avoid the purchase price paid in the LBO as a constructive fraudulent transfer under Section 548(a)(1)(B) of the Bankruptcy Code. Merit argued that the payment could not be avoided because it was a “settlement payment” or payment in connection with a securities contract subject to Section 546(e)’s safe harbor. Relying on authority out of the Second, Third, Sixth, and Eighth Circuits, Merit asserted that, under the plain language of Section 546(e), the payment was “made by or to (or for the benefit of)” a protected party because the purchase price passed through Citizens Bank and Credit Suisse on its way to Merit. The district court dismissed the fraudulent transfer claim, only to be reversed by the Seventh Circuit.

Five circuit courts have already weighed in on whether Section 546(e)’s safe harbor protects transfers that were made through a financial institution, but not ultimately from or to that protected party. The Second, Third, Sixth, and Eighth Circuits,[2] held that the plain language of the statute compels the application of the safe harbor because the transfers were literally made to the ultimate recipient “by” the financial institution through which the payment passed. This broad reading of the statute received no detailed discussion, even though it potentially immunized many payments in LBO transactions.

These decisions diverged from the earliest decision on this issue by the Eleventh Circuit.[3] *Munford* held that the safe harbor did not apply because the transfer at issue was not made “by or to” the financial institution intermediary because the financial institution never acquired a beneficial interest in the payment at issue. The Eleventh Circuit did not couch its decision in terms of any ambiguity in the statute, but held that Section 546(e)’s safe harbor could not be anchored by a financial intermediary that never held a beneficial interest in the payment.

The Seventh Circuit, in an opinion by Chief Judge Wood, sided with the Eleventh Circuit. *Merit* holds that Section 546(e) only protects a transfer for which a financial institution (or other protected party) is the actual start point, end point, or beneficiary of the transfer—not merely a conduit through which the transfer passed. *Merit* rejected the other circuits' plain language analysis, holding instead that the statute was ambiguous. The Seventh Circuit posited the question of whether "a postcard sent through the U.S. Postal Service could be said to have been sent 'by' the Postal Service or 'by' the sender who filled it out."[4] Similarly, "[t]he plain language does not clarify whether, under the statute, the transfer of the $16.5 million was made by Valley View to Merit; by Valley View to Citizens Bank; by Citizens Bank to Credit Suisse; or by Citizens Bank or Credit Suisse to Merit."[5]

The court then considered the safe harbor's purpose and context within the Bankruptcy Code. In particular, the court reviewed similar provisions in Sections 544, 547, 548, 550, and 550, and concluded that the economic substance of the transaction was the key to invoking the safe harbor, not whether the transfer touched a protected party on its way between the debtor and the defendant. On that point, the court found support in its own prior precedent that protected financial institutions that merely served as payment conduits from fraudulent transfer liability.[6]*Bonded Financial* considered the question of whether a bank that had acted as a financial intermediary and received no benefit from a transfer was a "transferee" within the meaning of Chapter 5 of the Bankruptcy Code, subject to fraudulent transfer liability for the transfer.[7] The *Bonded Financial* court concluded that the bank in that situation was not a transferee because it never had "dominion over the money" or "the right to put the money to [its] own purposes."[8]

The reference to *Bonded Financial* is apt. As the Second Circuit asserted in *Quebecor*, the purpose of Section 546(e)'s safe harbor is to "minimiz[e] the displacement caused in the commodities and securities markets . . . [i]f a [protected party] is required to repay amounts received in settled securities transactions. . . ."[9] If the protected party was merely a conduit and cannot be liable for the transfer, then there is no possibility of a domino effect that "infects" financial intermediaries and other protected parties.[10]

Merit leaves several questions unresolved. For example, does the safe harbor apply where the conduit is also a creditor in the bankruptcy case, such as a lending bank or swap participant with a security interest in the bank accounts through which the transfers passed? Financial institutions may be collateral damage in fraudulent transfer actions that, at a minimum, will be put to the expense of proving that they are conduits.

By joining the Eleventh Circuit, the Seventh Circuit's opinion widens the existing circuit split with the Second, Third, Sixth, and Eighth Circuits. Unless Congress steps in, the Supreme Court will need to resolve the split and define the scope of Section 546(e)'s safe harbor. In the meantime, the *Merit* opinion may lead debtors to forum shop before filing bankruptcy—especially if the debtor has recently completed an LBO or leveraged recap that might come under scrutiny in the debtor's bankruptcy case.

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[1] *FTI Consulting, Inc. v. Merit Mgmt. Group*, No. 15-3388 at *4 (7th Cir. July 28, 2016).

[2] *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013); *In re Resorts Int'l, Inc.*, 181 F.3d 505 (3d Cir. 1999); *In re QSI Holdings, Inc*., 571 F.3d 545 (6th Cir. 2009); *Contemporary Ind. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009).

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

[4] *Merit Mgmt. Group*, No. 15-3388 at *4 (7th Cir. July 28, 2016).

[5] *Id.* at 5.

[6] *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 893 (7th Cir. 1988).

[7] *Merit Mgmt. Group*, No. 15-3388 at *11.

[8] *Bonded Fin.*, 838 F.2d at 893.

[9] *See Quebecor World*, 719 F.3d at 100 (quoting *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.)*, 651 F.3d 329, 334 (2d Cir. 2011)).

[10] *Merit Mgmt. Group*, No. 15-3388 at *13.

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