CLIFFORD CHANCE

SUPREME COURT OPINES ON THE SCOPE OF THE SAFE HARBOR PROVISIONS

Merit Management Group, LP v. FTI Consulting, Inc.

In a decision entered last week, the Supreme Court determined to disregard intermediaries in connection with an "overarching transfer" between two parties that are not expressly protected by the Bankruptcy Code's Section 546(e) "safe harbor." The outcome was contrary to earlier decisions issued by the Second, Third, Sixth, Eighth and Tenth Circuits, which had found the safe harbor to be applicable where a protected entity was an intermediary.

Claw Back Actions and Section 546(e)

The Bankruptcy Code contains various provisions designed to recover payments and certain other transfers made by a debtor before a bankruptcy filing. Related litigations are commonly referred to as "claw back" actions. The goal of claw back actions is to maximize case recoveries. Types of claw back actions include so-called "constructive" fraudulent transfers. That action requires the return of transfers made for less than reasonably equivalent value while the debtor is insolvent or where the debtor becomes insolvent as a result. There are certain exceptions to claw back actions, one of which is a "safe harbor" found in Section 546(e).

Section 546(e) provides that certain types of transfers "made by or to (or for the benefit of)," among others, commodity brokers, stockbrokers, and financial institutions, *cannot* be avoided. The purpose of this exception, as articulated by Congress, was to prevent a "ripple effect" in the market; that is, Congress wanted to ensure that the insolvency of one commodity or security firm would not spread to other firms and possibly threaten the collapse of the affected market.

In some fraudulent conveyance cases decided after Congress enacted Section 546(e), defendants argued that because the transfer in question had passed through a Section 546(e) "protected party" (usually a financial institution), the transfer was protected from attack. Many of the courts agreed, concluding that a transfer may qualify for Section 546(e) protections even if a financial intermediary was merely a conduit in the transaction. The Second Circuit Court of Appeals explained that because the plain language of the statute refers to a transfer "by or to (or for the benefit of) a financial institution," the transfer at issue may be either "for the benefit of a financial institution or to a financial institution, but need not be both." Under that interpretation of 546(e), where a protected entity was involved in a multi-step transaction but never took title to the transferred asset, the asset (and the recipient of the asset) would still be protected from avoidance under Section 546(e). Not all courts agreed.

Merit Management

In *Merit*, two rival companies, Valley View Downs, LP and Bedford Downs Management Corporation, were vying for a single racing license that would allow them to operate a racetrack. Rather than continue to compete against each other, a deal was reached whereby Bedford Downs agreed to withdraw from the application process and Valley View agreed to purchase all of the stock in Bedford Downs held by its shareholders (including Merit Management Group) when Valley View obtained the license. Ultimately, Valley View obtained the license and proceeded with the acquisition. Both the purchase price and the stock certificates were delivered to a third-party escrow agent, Citizens Bank of Pennsylvania, who then distributed the stock and the purchase price to the parties.

Subsequently, Valley View and its parent, Centaur LLC, commenced Chapter 11 bankruptcy cases. Thereafter, a reorganization plan was confirmed and a litigation trust was established for Centaur. The trustee appointed in respect of the Centaur litigation trust filed suit against Merit seeking to avoid the transfer of $16.5 million (the portion of the purchase price asserted to have been received by Merit) for the sale of Bedford Downs stock as a constructive fraudulent transfer, asserting that Valley View was insolvent at the time of the transaction and had overpaid for the stock. In response, Merit sought to dismiss the action on the basis that the transfer was protected under the safe harbor of Section 546(e) of the Bankruptcy Code.

The Supreme Court Decision

The primary question articulated by the Supreme Court was "whether the transfer between Valley View and Merit implicates the safe harbor exception because the transfer was 'made by or to (or for the benefit of) a … financial institution'." As it was not disputed that the escrow agent, Citizens Bank, was a financial institution protected by Section 546(e), the Court decided that before it could determine whether the transfer was by, to or for the benefit of a covered entity, it was required to identify the relevant transfer at issue.

The Court ultimately concluded that the "overarching transfer" sought to be avoided was that transfer from Valley View to Merit for the purchase price of the stock. As neither Merit nor Valley View were asserted to be "financial institutions" or to otherwise fall under the protections of Section 546(e), the Court concluded that the transfer was outside of the scope of the safe harbor provision.

Some Preliminary Observations

The Section 546(e) safe harbor is frequently raised in constructive fraudulent conveyance lawsuits seeking to invalidate leveraged buy-out transactions and leveraged recapitalizations. The Supreme Court's decision likely has curbed the ability of defendants in such litigation to rely on the safe harbor. Additionally, the Supreme Court's focus on the "transfer the trustee seeks to avoid," has left open the possibility that plaintiffs strategically will determine to define the transfer in question to minimize the safe harbor protections that may be available. Only time will tell.

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