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NO SAFETY IN NUMBERS: SECTION 546 SAFE HARBOR PROVISION DOES NOT PROTECT OTHERWISE AVOIDABLE TRANSFERS SOLELY BECAUSE THEY PASS THROUGH INTERMEDIARY FINANCIAL INSTITUTIONS

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In *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S.Ct. 883, 200 L. Ed. 2d 183 (2018), the United States Supreme Court unanimously resolved a circuit split. It adopted the minority view that the safe harbor provision of section 546(e) of the Bankruptcy Code does not protect an otherwise avoidable transfer simply because it passes through a financial institution that is acting as an intermediary or conduit. The Supreme Court held the only relevant transfer for the purposes of section 546(e) is the overarching transfer the trustee seeks to avoid, and not its component parts.

As part of its bid to obtain the last available harness-racing license in Pennsylvania and build a "racino," the debtor, Valley View Downs ("Valley View"), agreed to purchase all of the stock of its competitor Bedford Downs ("Bedford") for $55 million. Valley View financed the purchase as part of a larger $850 million transaction with Credit Suise. Credit Suise wired the $55 million to Citizens Bank of Pennsylvania ("Citizens Bank"), who had agreed to act as a third party escrow agent for the transaction, holding both the purchase price and stock certificates. When the transaction was finally completed, Citizens Bank disbursed approximately $16.5 million to Merit, who owned roughly 30% of Bedford's stock.

Although it obtained the harness-racing license, Valley View was unable to obtain a gaming license, which was necessary to operate the casino portion of the racino. This failure led Valley View and its parent company to file a chapter 11 bankruptcy proceeding. Upon confirmation of a chapter 11 plan of reorganization appointing FTI Consulting, Inc. ("FTI") as the trustee of the debtor's litigation trust, FTI filed an action against Merit to recover the $16.5 million transfer as a fraudulent transfer pursuant to section 548 of the Bankruptcy Code.

Merit argued that section 546(e) protected the transfer from avoidance because it was a settlement payment "by or to (or for the benefit of)" a financial institution in connection with a securities contract, because the initial transfers were *to* Credit Suise and Citizens Bank. FTI did not dispute that the transfers satisfied the definitions of settlement payment and securities contract. Relying on the minority view in *Matter of Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996), FTI argued that a transfer to a financial institution acting only as a conduit or intermediary is not protected by section 546(e) because the financial institution does not have a beneficial interest in the transfer.

Both the bankruptcy and district courts rejected this argument and sided with the majority view that the plain language of section 546(e) is implicated even if the transfer is to a financial institution that is merely acting as an intermediary or conduit. On appeal, the Seventh Circuit reversed the lower court decisions. It found that section 546(e) applies to the "economic substance of the transaction", and the phrase "made by or to (or for the benefit of)" refers to the transferee, which the Seventh Circuit defined as an entity with dominion over or the right to put the money to its own use. To resolve the resulting conflict among the circuits, the Supreme Court granted certiorari.

In its decision affirming the Seventh Circuit's decision and adopting the minority view, the Supreme Court held the component parts of a transfer a trustee seeks to avoid are irrelevant to the applicability of the safe harbor rule. The only transfer that matters is the one the trustee seeks to avoid, as section 546(e) protects transfers made by or to a covered entity, but not transfers made through a covered entity. In this case, the Trustee sought to avoid the transfer from Valley View to Merit, not the component transfers to or from Credit Suise and Citizens Bank. Accordingly, their involvement in the transaction is irrelevant to the avoidability of the transfer. Or is it?

The Supreme Court's second footnote intimates the component parts of a transfer may still be relevant if the transferor or transferee is a customer of an intermediary financial institution. In the footnote, the Supreme Court stated it was not deciding whether Merit or the debtor qualified as a financial institution as defined in section 101(22)(A) of the Bankruptcy Code, thereby bringing the transfer within the safe harbor protection, because it was not argued or briefed. However, the Supreme Court noted the definition of financial institution in section 101(22)(A) includes a bank "acting as agent or custodian for a customer (whether or not a customer, as defined in section 741) in connection with a securities contract." In this case, there was no dispute that Credit Suise and Citizens bank were qualified financial institutions, or that the payment was a settlement payment in connection with a securities contract. Thus, the outcome of this case may have been different if Merit had argued that either it or Valley View qualified as a financial institution by virtue of being a customer of a covered entity acting as its agent in connection with a securities contract.