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# Safe Harbor After 'Merit Management'

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In *Merit Management Group v. FTI Consulting*, 138 S. Ct. 883 (2018), the Supreme Court settled a circuit split over whether the Bankruptcy Code §546(e) safe harbor applies when the only covered entity involved in the challenged transaction was an "intermediary," i.e., was involved in a "component part" of the transaction, but was not the initial transferor or the ultimate transferee. Section 546(e) prevents trustees from avoiding (primarily as a preference or constructive fraudulent conveyance) a transfer that is a margin or settlement payment, or a transfer in connection with a securities contract, commodity contract, or forward contract, that is made by, to, or for the benefit of certain covered entities, including financial institutions and financial participants. In *Merit Management*, the court ruled that "the relevant transfer for the purposes of the Section 546(e) safe harbor is the same transfer that the trustee seeks to avoid." Id. at 893. However, *Merit Management* also suggests that defendants may challenge the trustee's identification of the transfer to be avoided, and leaves the door open for an argument that transactions involving an intermediary covered entity constitutes two separate transactions, not a single overarching one.

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## Background

This dispute began out of the competition between Valley View and Bedford Downs to obtain the horse-racing license required to open a racetrack casino, or "racino." In 2007, Valley View and Bedford Downs decided to team up rather than continue to compete for the single available license. Under that agreement, Bedford Downs withdrew as a competitor for the license, and Valley View was to purchase all of Bedford Downs' stock for $55 million after Valley View obtained the license. Id. at 890-91.

'Merit Management' leaves the door open for an argument that transactions involving an intermediary covered entity constitutes two separate transactions, not a single overarching one.

Once Bedford Downs withdrew, Valley View was awarded the last harness-racing license. Valley View then proceeded with the acquisition of Bedford Downs. The transaction had three steps. First, Valley View arranged for Credit Suisse to finance the $55 million purchase price as part of a larger $850 million transaction. Then, Credit Suisse wired the $55 million to the third party escrow agent, Citizens Bank. Bedford Downs shareholders, including Merit Management, also deposited their stock certificates into escrow. After closing, Citizens Bank disbursed the $55 million, including $16.5 million to Merit. Id. at 891.

However, while Valley View received the horse racing license, it was unable to obtain a gaming license for slot machines, and could not open the racino. Valley View and its parent company, Centaur, then filed for bankruptcy. Id. FTI Consulting was appointed as the trustee of Centaur's litigation trust. FTI sued Merit, seeking to avoid the $16.5 million transfer from Valley View to Merit as a constructive fraudulent conveyance. Id. at 892. Merit moved for judgment on the pleadings, arguing that §546(e) barred FTI from avoiding the transfer. Id. The parties did not dispute that the intermediaries in the transaction were "financial institutions" under §546(e). Merit argued that, because

the payment to Merit was made in the first instance to a financial institution, the transfer to Merit was a transfer under a securities contract to a financial institution and thus exempt from avoidance under §546(e). Id.

### The Court's Analysis

The court first examined the language of §546(e) and the specific context in which that language is used. It noted that the first and last clause of §546(e) both refer to the sections of Title 11 which provide the Trustee with substantive avoiding powers, and that "[b]y referring back to a specific type of transfer that falls within the avoiding power, Congress signaled that the [safe harbor] exception applies to the overarching transfer that the Trustee seeks to avoid, not any component part of that transfer." Id. at 893. Next, the court recognized that the section heading for §546, "[l]imitations on avoiding powers[,]" demonstrated "the close connection between the transfer that the trustee seeks to avoid and the transfer that is exempted from that avoiding power pursuant to the safe harbor." Id. The court also flagged that §546(e)'s clause stating that "the trustee may not avoid" certain statutes invites scrutiny of the transfers that "the trustee may avoid," which is the parallel language used in the substantive avoiding powers provisions. Id. at 893-94.

Next, the court reviewed the broader statutory structure. Quoting the Seventh Circuit, the court noted that the Bankruptcy Code "creates both a system for avoiding transfers and a safe harbor from avoidance—logically these are two sides of the same coin … . Given that structure, it is only logical to view the pertinent transfer under Section 546(e) as the same transfer that the Trustee seeks to avoid." Id. at 894.

Given the results of its textual and structural analysis of §546(e), the court held that "the relevant transfer for the purposes of the Section 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid." Id. at 893. Thus, the court examined the transfer that FTI sought to avoid: the overarching transfer from Valley View to Merit. The fact that that transfer was made to a financial institution in the first instance was not relevant, as FTI was not seeking to avoid a transfer to the financial institution, but rather the transfer to Merit. Given that Merit was not a covered entity, the court ruled that the transfer was not protected by §546(e). Id. at 897.

### Safe Harbor After 'Merit Management'

While *Merit Management* requires courts to identify the specific transfer that the trustee seeks to avoid for the purposes of determining how to apply §546(e), it also suggests that defendants may challenge the trustee's identification of the transfer to be avoided. At oral argument, Justice Kagan noted that "relying entirely on the trustee's power to define the transfer" could allow trustees to evade §546(e). For instance, in a scenario where a trustee wanted to avoid a transfer from the debtor to a bank that would otherwise be protected by §546(e), the trustee could "ask where the bank then transferred the stock and … say that the transfer that [the trustee] want[s] to avoid is from the original debtor to whoever it was that the bank transferred the stock to, even though those really were two separate transactions." Unsurprisingly, the court's opinion was very pointed in stating that "Merit does not contend that FTI improperly identified the Valley View-to-Merit transaction as the transfer to be avoided … . Absent that argument, however, [the intermediary transfers] are simply irrelevant to the analysis under Section 546(e)." Id. at 895. The court also reiterated that if a trustee seeks to avoid a transfer to a covered entity that acted only as an intermediary, that entity is protected by §546(e), as long the transfer was made by, to, or for the benefit of that entity. Id. at 896.

Consequently, if a trustee attempts to frame a transfer involving an intermediary covered entity as a single transaction between a non-covered debtor to a non-covered final recipient, defendants may still provide the argument that was "absent" from *Merit Management*, and argue that the trustee has improperly identified the transfer to be avoided. In particular, defendants could argue that the transfer misidentified by the trustee is actually two separate transactions: a transfer from the debtor to the covered entity, then a second transfer from the covered entity to the final recipient. Since both the initial and subsequent transfer were by, to, and/or for the benefit of the intermediary covered entity, defendants could argue that both transfers would be covered by §546(e). They could also argue that this interpretation of *Merit Management* is supported by §550's distinction between "the initial transferee" and the "immediate or mediate transferee of such initial transferee[,]" which makes clear subsequent transferees are not transferees of the debtor, but are instead transferees of the "initial transferee." Thus, while *Merit Management* prevents courts from considering the "component parts" of the transaction that the Trustee seeks to avoid, the issue of whether those "component parts" can and should be considered separate transactions remains to be decided.

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