Supreme Court to consider statutory safe harbour for debtors' pre-petition securities transactions

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Introduction

Does the Bankruptcy Code bar a bankruptcy trustee from avoiding a debtor's constructively fraudulent pre-petition securities transactions merely because the deal was executed through a financial intermediary with no stake of its own in the transaction? The Supreme Court will address this question in *Merit Management Group, LP v FTI Consulting, Inc.*(1) The issue turns on the meaning of Section 546(e) of the Bankruptcy Code.

The avoidance powers are a vital part of the Bankruptcy Code's machinery for maximising the assets of bankruptcy estates, promoting equality of distribution among creditors and enforcing the priority scheme under which shareholders' rights are subordinate to those of creditors. The Bankruptcy Code therefore preserves causes of action whereby the trustee may obtain judgments setting aside the debtor's pre-petition transactions that constitute:

- preferences conferred on favoured creditors and insiders during the debtor's descent into bankruptcy;
- transfers that creditors could avoid under non-bankruptcy law if the debtor were not bankrupt;
- transfers made or obligations incurred with actual intent to "hinder, delay, or defraud" creditors; and
- constructively fraudulent transfers or obligations – that is, those the debtor made or incurred without receiving "reasonably equivalent value in exchange" when it was – or thereby became – insolvent, was under-capitalised or was intentionally incurring unsustainable debts.(2)

A separate provision of this statutory scheme defines the persons from whom the trustee may 'recover' assets disposed of in avoided transfers – or the value thereof – and establishes which of these potentially liable persons may escape liability as having received the transfer for value, in good faith and without knowledge of the transfer's voidability.(3)

The Bankruptcy Code circumscribes the avoidance powers in several ways. Some provisions impose deadlines for the trustee's commencement of avoidance actions, while others place certain categories of transaction beyond the trustee's reach. An example of the latter is Section 546(e),which provides that, notwithstanding the statutory avoidance powers generally available for attacking preferences and constructively fraudulent transfers, "the trustee may not avoid" a transaction that is a "settlement payment" or other "transfer... in connection with a securities contract" if such payment or transfer was "made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency." An express proviso preserves a cause of action for the trustee's avoidance of transfers tainted by actual fraudulent intent under Section 548(a)(1)(A).(4)

Facts

In *Merit Management Group* the US Court of Appeals for the Seventh Circuit held that the Section 546(e) safe harbour does not protect "transfers that are simply conducted *through* financial institutions" (emphasis added) if the financial institutions are "neither the debtor nor the transferee but only the conduit".(5) Disagreeing with five other circuit courts of appeals,(6) the Seventh Circuit carried on from a more than 20-year-old precedent in which the Eleventh Circuit ruled that, to gain the protection of Section 546(e), the securities transaction must be one in which the financial institution (or other participant of a kind described in that statute) "acquired a beneficial interest in either the funds or the shares".(7)

Merit Management Group involved a relatively uncomplicated transaction undertaken by a company, Valley View, that wanted to operate a 'racino' – that is, a racetrack facility that would include a casino. To increase its chances of obtaining the necessary harness-racing licence, the company acquired its main competitor by buying out shareholders for $55 million. Valley View borrowed the purchase price from Credit Suisse, and conducted the cash-for-shares exchange through another bank that acted as an escrow agent for collecting the shares and disbursing the funds. However, the venture failed when Valley View was unable to secure a gambling licence. It filed for bankruptcy and the trustee sued cashed-out shareholders of the former competitor to set aside the buy-out payments as constructively fraudulent transfers and claw back the cash. At the urging of a defendant 30% shareholder, the trial court found Section 546(e) applicable and held the transaction exempt from avoidance. On appeal, the Seventh Circuit reversed.

Appellate court decision

The appellate court acknowledged that "the transfer at issue is either a 'settlement payment' or a payment made 'in connection with a securities contract'", and there was no doubt that the lending bank and the escrow agent were both 'financial institutions'. However, the court rejected the idea that the payments that shareholders received for selling their stock gained entry to the safe harbour of Section 546(e) "based on the minor involvement" of the lender or the escrow agent. As the Seventh Circuit interpreted the statute, these payments were not "made by or to" or "for the benefit of" these financial institutions, and Section 546(e) was not intended to shield otherwise avoidable transfers merely because the exchange was administered through accounts that banks maintained for their customer.(8)

The several courts that reached contrary conclusions in similar circumstances rested on the statute's supposed plain meaning. Once satisfied that the ordinary sense of the statutory language did not lead to absurdity, they found it unnecessary and inappropriate to inquire further.(9) 'Plain meaning' is indeed the watchword of much Supreme Court jurisprudence about how the Bankruptcy Code should be read. However, in *Merit Management Group* the Seventh Circuit found the literal words of Section 546(e) to be impenetrably ambiguous:

> *"[A] postcard sent through the U.S. Postal Serve could be said to have been sent 'by' the Postal Service or 'by' the sender who filled it out. When a person pays her bills using an electronic bank transfer, the funds could be said to be sent 'by' the owner of the account or by the bank. Similarly, a transfer through a financial institution as intermediary could reasonably be interpreted as being 'made by or to' the financial institution or 'made by or to' the entity ultimately receiving the money. The plain language does not clarify whether, under the statute, the transfer of the $16.5 million was made by Valley View to [the shareholder]; by Valley View to [the escrow agent]; by [the escrow agent] to [the lender]; or by [the escrow agent] or [the lender] to [the shareholder]. These multiple plausible interpretations require us to search beyond the statute's plain language."*(10)

Therefore, the Seventh Circuit invoked another rule of statutory construction – namely, that a given law must be viewed in the context of the overall statutory scheme, and the part reconciled with the whole.(11) Noting that other Bankruptcy Code provisions made avoidance turn on the giving and receipt of value or the incurrence of an actual obligation, and viewing these provisions and the safe harbour statute as "two sides of the same coin", the court opined that it "makes sense to understand the safe harbor as applying to the transfers that are eligible for avoidance in the first place".(12)

Turning to legislative history, the court also described Section 546(e) as intended to "protect the market from systemic risk and allow parties in the securities industry to enter into transactions with greater confidence", so as to prevent any "large bankruptcy from rippling through the securities industry". It found these purposes to be inconsistent with protecting the stock purchases in *Merit Management Group*, since the transacting parties were not "parties in the securities industry", but "simply corporations that wanted to exchange money for privately held stock". Therefore, the court concluded, it would stretch Section 546(e) beyond its intended meaning to apply its protections to "any transaction involving securities that uses a financial institution... as a conduit for funds".(13)

In context, Section 546(e) seems to form part of a broad and dense statutory and regulatory scheme. That scheme focuses on the workings of public securities markets and in particular on the systemic risks associated with the collapse of entities that play a vital role in the process of settling trades. Chief among these are clearing agencies that facilitate trading by guaranteeing to each party its counter-party's performance. Standing behind both sides of a huge number of trades, these entities could expose entire markets to catastrophic downdrafts should they fail because of the unwinding of a major transaction. As one judge wrote in dissenting from the prevailing 'plain' reading of the statute:

> "*In 1975, Congress amended the Securities Exchange Act of 1934... to create a national system for the clearance and settlement of securities transactions. The predecessor of Section 546(e) was first enacted in 1978, and applied only to commodities markets. This left open the possibility that the avoidance provisions... could be applied to the settlement of securities transactions, and the failure to include securities transactions in the settlement safe harbor lent force to the argument that the clearing agencies were not entitled to protection from preference avoidance when they cleared securities transactions. This anomaly inadvertently jeopardized the national settlement system. Clearing agencies were exposed to risk because they were 'the critical link between the buyer's broker and the seller's broker'; they 'simultaneously guarantee[d]' the delivery of securities to the buyer and the delivery of the purchase price to the seller. In response to this concern, in 1982, Congress adopted substantially the current version of Section 546(e), which more broadly covered settlement payments.*"(14)

That Section 546(e)'s central focus on trading markets in commodities and securities justifies a narrowing interpretation has a certain appeal. It implies that the statute speaks to public trading in equity or debt securities but not to purely private transactions. Yet the statute incorporates by reference definitions of 'securities contract' and 'settlement payment' that do not confine these terms in any obvious way to publicly issued securities,(15) and the weight of authority has refused to exclude private transactions from the safe harbour.(16) Nor does the statutory listing of entities whose participation in a settlement payment invokes Section 546(e) – that is, "a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency" – necessarily imply that a transaction is safe-harboured only if such an entity acquires a stake of its own in the deal. Under the Bankruptcy Code's definition, it is clear that the term 'financial institution' is not limited to a bank acting for its own account, but rather refers to the bank's customer when the bank "is acting as agent or custodian for a customer... in connection with a securities contract".(17)

Arguments pro and con

The problems of statutory construction surrounding Section 546(e) have implications for transactions significantly different from the simple and relatively small-scale exchange that took place in *Merit Management Group*. Indeed, a pending petition for *certiorari* in another case invites the Supreme Court to overturn a ruling that exempted from avoidance the buy-out of public shareholders of the Tribune Company in a complex multi-billion dollar series of transactions that were conducted across public markets with the assistance of a clearing agency and other financial intermediaries.(18) In its attempt to overturn the lower court's ruling, the *Tribune* petitioner offers the same rationale that the Seventh Circuit embraced in *Merit Management Group*: namely, that the involvement of financial institutions as mere conduits, rather than as transferors or transferees, does not qualify the buy-out transaction for the safe harbour of Section 546(e). As of September 25 2017, the Supreme Court has not yet decided whether to accept the *Tribune* case for hearing. However, shareholder-defendants in the *Tribune* litigation, along with similarly situated defendants in the

Lyondell litigation (which arises from a massive cross-border leveraged buy-out) have filed a brief as *amici curiae* – 'friends of the court', who are not parties to the case and are not solicited by a party, but who assist the court by offering information – in *Merit Management Group*. In the brief, they contend that the Seventh Circuit "relied excessively on the facts of the small, private-market transaction before it, while ignoring the implications for the public securities markets of applying its interpretation of Section 546(e) to far larger, more complex securities transactions".(19)

To the Seventh Circuit's point that avoidance of the *Merit Management Group* transaction would pose no threat to the broader market, the petitioner responded that Congress is free to legislate more broadly than necessary to address existing problems. In other words, as the Supreme Court has said before, "[that] Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning".(20) The *amici* reinforced the theme of 'plain meaning' by arguing that the Seventh Circuit erred when it labelled Section 546(e) ambiguous just because it could be read as applying either to transfers made "by or to" a financial institution, or to ones "by or to" the principals, when the words themselves reasonably encompass both of these scenarios: "The court of appeals went awry in assuming that one had to be right to the exclusion of the other."(21) The *Merit Management Group* petitioner and the *amici* both point out that Congress could have insulated financial conduits by amending the recovery provisions of the avoidance powers accordingly, but instead wrote Section 546(e) to protect not just the entities that participate in securities contracts and settlement payments, but the transactions themselves. They contend that it is not for courts to weigh the potential destabilising effects of transactions that fit within the safe harbour as Congress wrote it, and note that if the legislators had meant to insist – as a prerequisite for safe-harbour protection – that the financial intermediary have or receive a beneficial interest in the property being exchanged, they would have made that requirement affirmative and explicit, rather than basing sanctuary on whether the transaction was made either "by or to" the intermediary or – as an alternative test – "for the benefit of" such an entity.(22)

Does the securities settlement system delineate a middle ground?

As postured by the parties, *Merit Management Group* seems to present the Supreme Court with a choice between two diametrically opposed readings of Section 546(e) – either:

- an interpretation under which the bankruptcy trustee has authority to challenge a debtor's pre-bankruptcy transaction in debt securities or equity securities as a preferential or constructively fraudulent transfer only if the deal was "done in cold hard cash" without even incidental services of a financial intermediary;(23) or
- an interpretation that immunises a securities transaction involving a financial intermediary only if the intermediary had a stake of its own in the transaction.

However, while asserting the broad interpretation as their primary argument, the *amici* also pointed to a possible middle ground by developing in technical detail the difference between the private transaction involved in *Merit Management Group* and buyouts conducted across public markets. This distinction turns on the intricacies of the so-called 'indirect holding system' through which large volumes of securities are publicly traded in the United States without the transfer or reissue of physical shares or similar instruments. In the *amici*'s view,

> *"Congress's use of words like 'securities clearing agency' in § 546(e) shows that public securities transactions consummated through the indirect holding system, like those in* Tribune *and* Lyondell*, were at the heart of Congress's concern in enacting the safe harbor."*(24)

This is a proposition that the appeals court in *Merit Management Group* would probably endorse. In the indirect holding system, participants deposit securities (for themselves or for their customers) with the Depository Trust Company (DTC), a registered clearing agency. Each depositor receives a *pro rata* interest in DTC's entire inventory of securities for that particular issue, while relinquishing ownership of any specific share of stock or debt security deposited. The *amici* explain that:

> *"Ownership of securities held through the indirect holding system is governed by state law, in accordance with Article 8 of the UCC [the Uniform Commercial Code], which provides for a system of 'security entitlements,' i.e., 'the rights and property interest of a person who holds*

> *securities or other financial assets through a securities intermediary.' Individual investors have securities entitlements against their banks or brokers, which may be DTC Participants or may have deposited the securities with DTC Participants, in which case the bank or broker would have a securities entitlement against the Participant. The Participants would then have securities entitlements against DTC. Significantly, DTC does not know whether its Participants are acting for themselves or customers, or the identity of the ultimate owners. In many instances, as in* Tribune *and* Lyondell, *there may be several tiers of securities intermediaries between DTC and the ultimate owners... At each tier, the entitlement holder has only a securities entitlement against its securities intermediary*."(25)

In a footnote, the *amici* suggested that each link in the chain of securities entitlements constitutes a beneficial interest of sorts and thus provides a basis on which courts could admit "most contemporary securities transactions" (and the *Tribune* and *Lyondell* transfers) to the safe harbour of Section 546(e), even if the Supreme Court denies this refuge to the private stock purchases involved in *Merit Management*.(26) However, the *amici* acknowledged that when the Seventh Circuit deemed the private stock purchases unprotected in *Merit Management Group* for lack of any beneficial interest on the part of the financial institutions involved, the court had in mind property interests tantamount to those of the ultimate owners of securities. As already noted, many courts have rejected the idea that the statute protects public transactions but not private ones.

As the *amici's* footnote emphasises, the clearing and settlement of publicly traded securities is a highly technical and complicated business. If Congress wrote Section 546(e) with that business in mind, 'plain meaning' may be an inadequate, and indeed misleading, principle for interpreting this statute.

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Endnotes

(1) See Brief for Petitioner at 42, *Merit Management Group, LLP v FTI Consulting, Inc*, Case 16-784 (US Sup Ct).

(2) See 11 USC Sections 544, 545, 547.

(3) See *id* Section 550.

(4) The quotation above gives the portions of Section 546(e) most relevant to *Merit Management*.

> "*Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title,* the trustee may not avoid a transfer that is a *margin payment, as defined in section 101, 741, or 761 of this title,* or settlement payment*, as defined in section 101 or 741 of this title,* made by or to (or for the benefit of) a *commodity broker, forward contract merchant, stockbroker,* financial institution, *financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract,* that is made before the commencement of the case*, except under section 548(a)(1)(A) of this title.*" (Emphasis added.)

11 USC Section 546(e) (emphasis added).

(5) *FTI Consulting, Inc v Merit Management Group, LP*, 830 F3d 690, 691 (7th Cir 2016).

(6) See *Enron Creditors Recovery Corp v Alfa, SAB de CV*, 651 F3d 329 (2d Cir 2011); *In re QSI Holdings, Inc*, 571 F3d 545 (6th Cir 2009); *Contemporary Indus Corp v Frost*, 564 F3d 981 (8th Cir 2009); *In re Resorts Int'l, Inc*, 181 F3d 505 (3d Cir 1999); *In re Kaiser Steel Corp*, 952 F2d 1230 (10th Cir 1991).

(7) *Merit Management Group*, 830 F3d at 697 (quoting *Matter of Munford, Inc*, 98 F3d 604, 610 (11th Cir 1996)).

(8) See *id* at 692, 697.

(9) See *eg*, *Resorts Int'l*, 181 F3d at 515.

(10) *Merit Management Group*, 830 F3d at 692.

(11) See *id* at 693.

(12) *Id* at 694; see *id* at 693-95.

(13) *Id* at 696 (quoting with emendations *Grede v FCStone, LLC*, 746 F3d 244, 252 (7th Cir 2014) (internal quotation marks omitted); *id* at 697.

(14) *Enron Creditors Recovery Corp*, 651 F3d at 343 (Koeltl, DJ, dissenting) (citations and footnotes omitted). See generally *Seligson v New York Produce Exchange*, 394 F Supp 125 (SDNY 1975). *Seligson* was a trustee's action against a clearing agency and a commodities exchange to claw back margin payments made by a commodities futures broker brought down by adverse price movements in the market. The trial court ruled that factual issues precluded summary judgment in its favour, including whether the broker was insolvent when it made the payments, whether it received fair consideration in return and whether the clearing house was a disclosed agent for its members (and thus a mere conduit of the payments) or instead a transferee in its own right. The decision prompted Congress to enact the original precursor of Section 546(e).

(15) See 11 USC Section 546(e) (referring to 11 USC Section 741. Section 741 is part of a subsection of the Bankruptcy Code that addresses the liquidation of stockbrokers. Although it is elaborate and multi-faceted, its definition of 'securities contract' begins with the simple statement that the term includes "a contract for the purchase, sale, or loan of a security" (11 USC Section 741(7)). A 'settlement payment' is "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade". *Id* Section 741(8). This circular definition makes sense only if it implicitly takes for granted the usage common in the securities industry.

(16) See *In re Quebecor World (USA) Inc*, 719 F3d 94 (2d Cir 2013); Contemporary Indus Corp, 564 F3d at 987; *In re Plassein Int'l Corp*, 590 F3d 252, 258-59 (3d Cir 2009); *QSI Holdings*, 571 F3d at 550.

(17) 11 USC Section 101(22)(A).

(18) See Brief for Various Former Tribune and Lyondell Shareholders as *Amici Curiae* in Support of Petitioner, *Merit Management Group, LLP v FTI Consulting, Inc*, Case 16-784 (US Sup Ct) [hereinafter cited as 'Brief for *Amici*']. See also *In re Tribune Co Fraudulent Conveyance Litig*, 818 F3d 98, 112 (2nd Cir 2016); Petition for a Writ of *Certiorari*, *Deutsche Bank Trust Co Americas v Robert R McCormick Foundation*, 16-317 (Sup Ct).

(19) Brief for *Amici* at 4-5.

(20) *Union Bank v Wolas*, 502 US 151, 157-58 (1991). See Brief for Petitioner at 42.

(21) Brief for *Amici* at 12.

(22) See Brief for Petitioner at 17-18, 24, 29; Brief for *Amici* at 12-13, 21-22.

(23) *Merit Management*, 830 F3d at 69; see Brief for Petitioner at 44-46.

(24) Brief for *Amici* at 10.

(25) *Id* at 8-9.

(26) See *id* at 9 n3.