

Supreme Court Limits Safe Harbor Defense in Bankruptcy “Clawback” Suits

March 12, 2018

Recently, the United States Supreme Court decided *Merit Management Group, LP v. FTI Consulting, Inc.*, a decision that has potentially far-reaching implications for a broad range of business transactions, particularly leveraged stock deals. In the opinion, the Court unanimously held that the so-called “securities safe harbor” does not insulate parties from clawback liability for transfers from an entity that later files for bankruptcy merely because the transfer was routed through a financial intermediary. In affirming a 2016 decision by the Seventh Circuit Court of Appeals, the Supreme Court effectively overruled conflicting decisions from the Second, Third, Sixth, Eighth and Tenth Circuits.

As a general matter, the Bankruptcy Code vests a bankruptcy estate with an arsenal of “avoidance powers” that permit the estate to unwind various types of prepetition transfers that prejudice creditors or impermissibly prefer one creditor over others. The avoidance powers further the bankruptcy principle of equality of distribution among similarly situated creditors and are designed to deter the debtor and its creditors from stripping the debtor of valuable assets in times of financial distress.

The estate’s authority to avoid transfers is not absolute, however. Until the Supreme Court’s *Merit Management* decision, one increasingly valuable shield of recipients of such preferential or constructively fraudulent transfers in securities transactions is the “safe harbor” contained in Section 546(e) of the Bankruptcy Code, which provides that a trustee may not avoid:

“[a] transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a . . . financial institution . . . or a transfer made by or to (or for the benefit of) a . . . financial institution. . . in connection with a securities contract . . .” (emphasis added)

The *Merit Management* decision arose from the \$55 million acquisition by Valley View Downs of all of the outstanding stock of BDMC, 30% of which was owned by Merit Management. Valley View’s purchase was financed by Credit Suisse, and Citizens Bank served as escrow agent. At Valley View’s direction, Credit Suisse wired its loan proceeds directly to Citizens Bank which, upon receiving selling shareholders’ stock, closed the transaction and distributed 30% of the aggregate purchase price to Merit Management.

After Valley View failed, its bankruptcy estate sued Merit Management, contending that Valley View had “substantially overpaid” for the BDMC stock and seeking to claw back Merit Management’s share of the purchase price. In response, Merit Management cited section 546(e) and the other Circuit Court of Appeals cases described above and asserted that the payment could not be avoided because the transfers from Credit Suisse to Citizens Bank and from Citizens Bank to Merit Management were transfers “by or to” a financial institution. Although the trial court ruled in Merit Management’s favor, both the Seventh Circuit and the Supreme Court disagreed and held that Section 546(e) did not protect Merit Management because it (unlike Credit Suisse and Citizens Bank) was not itself one of the entity types listed in Section 546(e). The Supreme Court specifically held that the relevant transfer for the purposes of the “safe harbor” analysis is the overarching transfer sought to be avoided (i.e. from Valley View to Merit Management), not one or more of the intermediate transfers that comprised that overarching transfer (i.e. from Credit Suisse to Citizens Bank to Merit Management). Thus, the payment by Valley View to Merit Management was not protected, and the facilitating transfers by Credit Suisse and Citizens Bank were irrelevant.

At least in the short term, the *Merit Management* decision appears to narrow considerably the 546(e) safe harbor for defendants in clawback litigation. There are, however, significant questions concerning its application that will continue to be litigated in the lower courts, including what qualifies as a “financial institution” or other entity protected by the safe harbor, as well as the extent to which Section 546(e) preempts fraudulent conveyance claims brought under state laws, which generally do not contain a similar safe harbor.



This alert was authored by Thomas C. Wolford (312-269-5675, twolford@nge.com).
If clawback litigation is brought or threatened against you, please feel free to contact the author or any member of the [Financial Restructuring & Bankruptcy group](#) to discuss applicability of the safe harbor and the myriad of other potential defenses that may be available to you.

BANKRUPTCY ALERT

Please note that this publication should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents of this publication are intended solely for general purposes, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have.

The alert is not intended and should not be considered as a solicitation to provide legal services. However, the alert or some of its content may be considered advertising under the applicable rules of the supreme courts of Illinois and certain other states.

© Copyright 2018 Neal, Gerber & Eisenberg LLP