SUPREME COURT LIMITS THE AVOIDANCE PROTECTION OF BANKRUPTCY CODE § 546(e) WHERE BANKS ARE MERE CONDUITS OF FRAUDULENT TRANSFERS

On February 27, 2018, the United States Supreme Court in the case of *Merit Management Group, LP v. FTI Consulting, Inc.* settled a long standing split among Federal Circuit Courts by affirming the decision of the Seventh Circuit Court of Appeals holding that the safe harbor provisions of Bankruptcy Code § 546(e), which protect certain transfers from avoidance, do not apply in the case where financial institutions, subject to the protection of the statute, are mere conduits of funds and not the parties making or receiving the transfer.

Valley View Downs, LP and Bedford Downs Management Corp. were competitors in the harness racing business in Pennsylvania. Valley View and Bedford agreed that if Valley View acquired the last available harness racing license it would purchase all of Bedford Downs' stock for $55 million. Valley View obtained the license and instructed its lender, Credit Suisse, to wire $55 million to Citizens Bank, the escrow agent for the transaction. Citizens then distributed the $55 million to the former Bedford shareholders, including $16 million to Petitioner Merit Management Group, LLC. Valley View and its parent Centaur, LLC experienced financial problems and filed petitions under Chapter 11. Respondent FTI Consulting, Inc. was appointed as litigation trustee of the Centaur Litigation Trust. FTI filed an action in District Court for the Northern District of Illinois seeking to avoid the transfer from Valley View to Merit as a fraudulent transfer under the provisions of Bankruptcy Code § 548(a)(1)(B). Merit argued that the § 546(e) safe harbor provisions were a valid defense because the transfer was a "settlement payment…made by or to (or for the benefit of) two financial institutions, Credit Suisse and Citizens Bank." The District Court agreed with Merit, but the Seventh Circuit reversed, holding that § 546(e) did not protect transfers in which financial institutions served as mere conduits.

In a unanimous opinion the Supreme Court ruled that the safe harbor provisions of § 546(e) must be viewed in the context of the relevant transaction and agreed with FTI's position that the "overarching transfer" between Valley View and Merit was the only relevant transaction and the fact that two financial institutions acted as "conduits" to complete the transfer did not provide a defense to Merit under § 546(e).

The Supreme Court rejected Merit's argument that the relevant transaction was more than a simple payment by Valley View to Merit but that each component part, i.e., the transfers from Credit Suisse to Citizens Bank and from Citizens Bank to Merit, should also be considered. In a lengthy analysis the Supreme Court held that the only transfer subject to review under § 546(e) is the same transfer which is subject to avoidance under § 548(a)(1)(B). In addition, the Supreme Court noted that since Valley View and Merit are not entities covered by the statute, the transfer is outside of the scope of the safe harbor of § 546(e).

Finally, Merit argued that Congress intended to adopt a broad reading of § 546(e) to protect the securities industry not only from transfers made by a financial institution but also from transfers made through a financial institution. The Court noted that this argument was refuted by the plain language of the statute which would not preclude the trustee from avoiding a transfer made through a financial institution by a party not protected by § 546(e).

If you have any questions regarding the Merit decision, or its impact on future transactions, please feel free to contact Ed Zujkowski (212-238-3021) or Tom Pitta (212-238-3148), Partners in Emmet's restructuring group.