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Client Alert

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Merit Management Narrows Bankruptcy Code Section 546(e) Safe Harbor, But Leaves Undisturbed Critical Safe Harbor Technique Deployed by Many Structured Finance Transactions

The U.S. Supreme Court recently scrutinized the proper application of the safe harbor found in Section 546(e) of the U.S. Bankruptcy Code[1] in *Merit Management Group, LP v. FTI Consulting Inc.*[2] While the Supreme Court's decision narrowed the reach of the safe harbor, it did little to change the landscape for the multi-billion dollar U.S. structured finance industry, including warehouse lending.

Merit Management. At issue in *Merit Management* was the scope of Section 546(e), which prohibits bankruptcy trustees from avoiding settlement payments, margin payments and transfers in connection with a securities contract ("*Qualified Transfers*") made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency ("*Qualified Entities*"). Both Qualified Transfers and Qualified Entities must exist to enjoy safe harbor protection under Section 546(e). Specifically, the Court considered whether Section 546(e) protects from avoidance Qualified Transfers by and to entities that are not Qualified Entities themselves if such transfers *pass through* Qualified Entities. The Supreme Court said no, concluding that Section 546(e) requires evaluation of the entities making the specific transfer a trustee seeks to avoid, not intermediaries facilitating the same.[3]

In *Merit Management*, Valley View Downs LP ("*Valley View*") made a payment to Merit Management Group, LP ("*Merit*") for the purchase of Merit's stock in Bedford Downs Management Corp. ("*Bedford*"). Valley View did not make the payment directly to Merit, but instead, transferred it indirectly to Merit through Credit Suisse and a third-party escrow agent, Citizens Bank of Pennsylvania ("*Citizens Bank*"). Subsequently, Valley View filed for bankruptcy. The bankruptcy court appointed a litigation trustee, FTI Consulting Inc. ("*FTI*"), which sued Merit to avoid the Valley View payment as a constructively fraudulent transfer under Section 548(a)(1)(B). In defense, Merit invoked the safe harbor of Section 546(e) arguing that the transfer was a settlement payment made by or to or for the benefit of a "financial institution" because it passed through Credit Suisse and Citizens Bank, both Qualified Entities, before reaching Merit.

While the Seventh Circuit focused on the meaning of the words "by or to (or for the benefit of)" used in Section 546(e), the Supreme Court found this question premature because a court must first identify the relevant transfer for purposes of the safe harbor.[4] FTI sought to avoid the overarching transfer from Valley View to Merit. As such, the Court concluded that the component parts of the transfer were

[1] *See* Title 11 of the United States Code, 11 U.S.C. §§ 101–1532.
[2] *Merit Management Group, LP v. FTI Consulting Inc.*, No. 16-784, 583 U.S. __ (U.S. Feb. 27, 2018) ("*Merit Management*").
[3] *Merit Management* at 18-19.
[4] *Id.* at 10. *See also FTI Consulting v. Merit Management Group*, 830 F.3d 690 (7th Cir. 2016).

irrelevant absent an argument by Merit that FTI improperly identified the transfer to be avoided.[5] Merit neither challenged FTI's designation of the Valley View-to-Merit transfer as the avoidable transfer, nor argued that either Valley View or Merit were Qualified Entities. Thus, the Court had no reason to consider the components of the transfer because Section 546(e) defines the limit on the trustee's avoiding power by reference to an otherwise avoidable transfer.[6] Because FTI sought to avoid the transfer from Valley View to Merit and neither Valley View nor Merit were Qualified Entities under Section 546(e), the Supreme Court held that the transfer fell outside the Section 546(e) safe harbor.[7]

Warehouse Structures. Typical warehouse structures involve transferors and transferees that outright qualify as a "financial institution," "financial participant," or other entity covered by Section 546(e) (i.e. a Qualified Entity). When neither entity qualifies, parties often structure warehouse transactions to include the use of a qualified custodian or agent to act on behalf of the transferor or transferee. This type of structure relies on the definition of "financial institution" found in Section 101(22)(A), which includes Federal Reserve banks, commercial or savings banks, industrial savings banks, savings and loan associations, trust companies and federally-insured credit unions as well as customers of any of these entities when the Qualified Entity acts as agent or custodian for such customer in connection with a securities contract.[8] When a non-qualified entity relies on the Qualified Entity boot-strap under Section 101(22)(A), such non-qualified entity becomes itself, by definition, a Qualified Entity.

Significantly, the Supreme Court in *Merit Management* noted that neither party raised the issue of whether Valley View or Merit qualified as a "financial institution" as a result of its status as a "customer" of a "financial institution."[9] As a result, the Supreme Court did "not address what impact, if any, §101(22)(A) would have in the application of the §546(e) safe harbor," suggesting that the result may have been different had the parties addressed this issue.[10]

Thus, *Merit Management* does not disturb safe harbor protection for warehouse lending structures relying on the use of custodians or agents to qualify an otherwise non-qualified entity as a Qualified Entity. Properly crafted structured finance transactions still should enjoy the protection of the Section 546(e) safe harbor.

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[5] *Merit Management* at 14.
[6] *Id*.
[7] *Id*. at 19.
[8] 11 U.S.C. § 101(22).
[9] *Merit Management* at 6, n. 2.
[10] *Id*. In fact, at oral argument, Justice Breyer asked why this argument was not raised in the lower courts or in the parties' briefing, but counsel to Merit did not have an explanation:

> JUSTICE BREYER: Now, it seems to me that Citizens Bank is acting for agent or custodian of a customer, namely VVD, and it seems to me that Credit Suisse is acting as a – as an agent or custodian for VVD. So why doesn't that cover it?
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> MR. WALSH: I think that is a fair way to look at it, Your Honor.
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> JUSTICE BREYER: Well, why doesn't that cover it? Why are we dealing with a case . . . where this is absolutely dealt with in a statute, under – under another provision, and nobody refers us to that provision, and I can't understand why they didn't – what's going on?

Transcript of Oral Argument at 16, 9:25.