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Circuit Split Deepens on Scope of § 546(e) by Recognizing Limits on the Application of the Safe Harbor

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In reversing the district court's decision in *FTI Consulting Inc. v. Merit Management Group LP*, the Seventh Circuit revived and deepened an over-two-decade split among the judicial circuits concerning the scope of the safe harbor from fraudulent transfer liability, codified in § 546(e) of the Bankruptcy Code.[2] Section 546(e) provides that a bankruptcy trustee may not avoid certain pre-petition transfers (*e.g.*, settlement payments and transfers made in connection with a securities contract) that were "made by or to" a "commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency."[3] The specific issue before the Seventh Circuit was the deceptively complex question of the proper interpretation of the statutory phrase "made by or to."[4]

The Second, Third, Sixth, Eighth and Tenth Circuits have adopted a broad interpretation of this phrase.[5] Each of these courts has held that Congress used the words "by" and "to" in the safe harbor to immunize all settlement payments and transfers made in connection with securities contracts from avoidance where the challenged transfers merely passed *through* any of the financial institutions named in the statute. It follows from this interpretation that the safe harbor applies — so long as the relevant securities-related transfer was made by check, wire transfer or similar mechanism — regardless of whether the debtor or transferee was an entity identified in the statute. As a result, under this interpretation virtually all securities-related payments (except those made in cash or with payments in-kind) would fall within the safe harbor. By applying the safe harbor to "transactions rather than firms," the majority view drastically limits the avoidance powers of trustees.[6]

The Seventh Circuit expressly rejected this line of reasoning. After considering the statutory language, the statute's context and purpose, and its legislative history, the court held that "by or to" does not mean or include "through."[7] The court reasoned that Congress intended for the safe harbor to apply only in "cases in which the debtor-transferor or transferee is a financial institution or other named entity."[8] In reaching this conclusion, the Seventh Circuit followed a decision from the Eleventh Circuit and rejected the majority view that the safe harbor is so "expansive ... that it covers any transaction involving securities" in which the debtor or defendant used "a financial institution or other named entity as a conduit for the funds."[9]

Background

The case at issue arose from the bankruptcy of Valley View Downs LP. Prior to its bankruptcy, Valley View acquired all of the stock in Bedford Downs Management Corp. for $55 million in cash. Merit Management Group LP, the largest shareholder of Bedford Downs, received more than $16.5 million from the transaction. To finance the acquisition of Bedford Downs' stock, Valley View borrowed money from Credit Suisse and other lenders. Another financial institution, Citizens Bank of Pennsylvania, served as escrow agent for the stock purchase, receiving the purchase price before passing it along to Merit and the other Bedford Downs shareholders. Within two years of the transaction, Valley View filed a chapter 11 in Delaware. Neither Valley View nor Merit are any of the entities identified in § 546(e).

Circuit Split Prior to the Seventh Circuit's Opinion

The majority of the case law on the meaning of the phrase "made by or to" as used in § 546(e) developed in the wake of the Eleventh Circuit's 1996 opinion in *Matter of Munford Inc.*[10] In *Munford*, the trustee brought claims to avoid transfers made by Munford to its shareholders in connection with a leveraged buyout. The court recognized that "a section 546(e) financial institution was presumptively

1 The authors represented FTI Consulting Inc. in *FTI Consulting Inc. v. Merit Mgmt. Grp. LP* before the Seventh Circuit Court of Appeals.
2 *FTI Consulting Inc. v. Merit Mgmt. Grp. LP*, 15-3388, 2016 WL 4036408, at *1 (7th Cir. July 28, 2016).
3 11 U.S.C. § 546(e).
4 *FTI Consulting*, 2016 WL 4036408, at *1.
5 *See In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 (10th Cir. 1991); *In re Resorts Int'l. Inc.*, 181 F.3d 505, 516 (3d Cir. 1999); *In re QSI Holdings Inc.*, 571 F.3d 545, 551 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009); *Enron Creditors Recovery Corp. v. Alfa, SAB de CV*, 651 F.3d 329, 338 (2d Cir. 2011).
6 *See In re Tribune Co. Fraudulent Conveyance Litig.*, 818 F.3d 98, 121 (2d Cir. 2016).
7 *FTI Consulting*, 2016 WL 4036408, at *1.
8 *Id.* at *6.
9 *Id.*
10 *Matter of Munford Inc.*, 98 F.3d 604, 610 (11th Cir. 1996). *Munford* started the circuit split by implicitly disagreeing with the Tenth Circuit's ruling in *In re Kaiser Steel.*

involved in the transaction."[11] Nevertheless, the court held that § 546(e) did not apply because neither the debtor nor the transferees (*i.e.*, the shareholders) were entities protected by the statute. The court reached this conclusion by citing § 550 of the Bankruptcy Code for the uncontroversial proposition that "a trustee may only avoid a transfer to a 'transferee."[12] Next, the court determined that the relevant financial institutions were not "transferees" because they "never acquired a beneficial interest in the funds."[13] As such, and because the shareholder/transferees were not any of the entities listed in the statute, § 546(e) did not apply to the transaction.

However, the *Munford* decision was not unanimous. The two-sentence dissent simply stated, without citation to any authority, that the majority was "disregard[ing] the plain language of section 546(e) to create a new exception to its application."[14]

The next circuit court to address the meaning of the phrase "made by or to" was the Third Circuit in *In re Resorts International*.[15] The *Resorts* court adopted — with no analysis of its own — the *Munford* dissent.[16] Thereafter, the Second, Sixth and Eighth Circuits followed suit and adopted the holding in *Resorts*, also with little (if any) independent analysis of the statutory language.[17]

However, the Second Circuit recently expounded on its interpretation of the safe harbor in *In re Tribune*.[18] In its opinion, the Second Circuit reiterated that "[t]ransfers in which either the transferor or transferee" are not one of the enumerated entities "are clearly included in the language" of the safe harbor.[19] To reach this conclusion, the Second Circuit relied on portions of the safe harbor's legislative history to read the policy objective of protecting investors "from the disruptive effect of after-the-fact unwinding of securities transactions" into the statutory language.[20]

The Path to the Seventh Circuit

Given the weight of the majority view, FTI Consulting Inc., the trustee of the litigation trust formed in the plan of Valley View's bankruptcy, knew that it was facing an uphill legal battle to recover the pre-petition transfers made to Merit. Recognizing that Third Circuit precedent on § 546(e) would effectively bar a recovery, the trustee opted to sue Merit in the U.S. District Court for the Northern District of Illinois, rather than in the U.S. Bankruptcy Court for the District of Delaware, where the bankruptcy was pending. Critically, at the time of the complaint, the Seventh Circuit had yet to rule on the application of § 546(e) to securities-related transfers that merely passed through one of the entities enumerated in the statute.

Merit moved to transfer the case to Delaware in an attempt to have the case decided under Third Circuit law. In opposing the motion, the trustee admitted that it had purposefully brought the action in the best possible available jurisdiction for its claim, but argued that it was entitled to do so. The trustee further contended that Merit was improperly attempting to forum-shop by requesting a transfer to Delaware — a less-convenient forum for Merit, given that Merit was based in Chicago. The Illinois district court agreed with the trustee and denied the motion to transfer, holding that a plaintiff "has every right to file in the forum ... that has the most favorable law" for its claims.[21]

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Next, Merit filed a motion for judgment on the pleadings under Fed. R. Civ. P. 12(c), arguing that the trustee's claims were barred by § 546(e). Merit admitted that neither it nor the debtor was one of the entities identified in the safe harbor. Merit nonetheless argued — citing the Second, Third, Sixth, Eighth and Tenth Circuits' broad interpretation of the meaning of the phrase "made by or to" — that the trustee could not recover the stock payment because at least two financial institutions (Credit Suisse and Citizens Bank) acted as conduits for the transfers.

The district court agreed with Merit and held that "a transfer that is 'by or to' a financial institution is just that: a transfer where a financial institution sends or receives funds."[22] Since there was no dispute that Valley View and Merit used financial institutions to send and receive the funds, the district court granted Merit's motion. The trustee appealed to the Seventh Circuit.

Section 546(e) Interpreted Within Context of Chapter 5 and Code as Whole

Although the scope of the § 546(e) safe harbor has been heavily litigated over the last 20 years, the trustee was the first plaintiff to focus its entire argument solely on the meaning of words "by" and "to" in the statute. In so doing, the trustee advanced several statutory-interpretation arguments that no court interpreting § 546(e) had previously addressed.

The Seventh Circuit, in an opinion written by Chief Judge Diane Wood, found the trustee's arguments persuasive and reversed the judgment of the district court. The Seventh Circuit began its opinion by articulating how the words "by" and "to" are ambiguous. The court reasoned that "a transfer through a financial institution as [an] 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."[23] The court held that "these multiple plausible interpretations" of the statutory text required that it "turn to the statute's purpose and context for further guidance."[24]

11 *Id.*
12 *Id.*
13 *Id.*
14 *Id.* at 614 (Hatchett, C.J., dissenting).
15 *In re Resorts Int'l*, 181 F.3d at 516.
16 *Id.*
17 *See Contemporary Indus.*, 564 F.3d at 987; *In re QSI*, 571 F.3d at 551; *In re Quebecor World (USA) Inc.*, 719 F.3d 94, 99 (2d Cir. 2013).
18 *In re Tribune*, 818 F.3d at 122-23.
19 *Id.*
20 *Id.*
21 *FTI Consulting Inc. v. Merit Mgmt. Grp. LP*, 11 CV 7670, 2014 WL 3858365, at *5 (N.D. Ill. Aug. 5, 2014).
22 *FTI Consulting Inc. v. Merit Mgmt. Grp. LP*, 541 B.R. 850, 859 (N.D. Ill. 2015).
23 *FTI Consulting*, 2016 WL 4036408, at *2.
24 *Id.*

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To resolve the ambiguity, the Seventh Circuit attempted to read § 546(e) in harmony with other sections of chapter 5. It reasoned that "it makes sense to understand the safe harbor as applying only to the transfers that are eligible for avoidance in the first place."[25] The court then examined various provisions of chapter 5 — including §§ 544, 547, 548, 550 and 555 — and concluded that the only way to read these provisions in harmony with § 546(e) was to read the safe harbor as immunizing only those securities-related transfers made "by" a debtor that is an entity named in the statute or made "to" a "transferee" that is an entity named in the statute.[26]

Like the Eleventh Circuit's decision in *Munford*, the Seventh Circuit found the question of whether an entity named in the statute was a "transferee" of the challenged transfer critical to its analysis. In considering this question, the court turned to its previous decision in *Bonded Financial Services Inc. v. European American Bank*, in which it defined a "transferee" as an entity with "dominion over the money" or "the right to put the money to one's own purposes."[27] The Seventh Circuit then held that "transfers 'made by or to (or for the benefit of)' in the context of § 546(e) refer to transfers made to 'transferees," as defined by *Bonded*.[28]

Since the financial intermediaries involved in the payment from Valley View to Merit did not have "dominion over the money" or the "right to put the money to [their] own purposes," the Seventh Circuit concluded that the payment was not made either "by" or "to" them. Rather, looking to the "economic substance of the transaction," the Seventh Circuit concluded that the transfer was made by Valley View (the debtor) to Merit (the defendant).[29]

Finally, the Seventh Circuit turned to the policy considerations underlying the safe harbor. The court stated that it was "not troubled by any potential ripple effect through the financial markets" because there was no evidence that Valley View's bankruptcy would "trigger bankruptcies of any commodity or securities firms."[30] The court further stated that permitting the trustee to recover from Merit would not "have any impact on Credit Suisse, Citizens Bank, or any other financial institution or entity named in section 546(e)."[31] The Seventh Circuit concluded that it was not "persuaded that the repercussions of undoing a deal like this one outweigh the necessity of the Bankruptcy Code's protections for creditors."[32]

The Stage Is Set for Supreme Court to Decide the Issue

The § 546(e) safe harbor stands "at the intersection of two important national legislative policies on a collision course — the policies of bankruptcy and securities law."[33] The circuit courts are now split 5-2 on how broadly to apply the safe harbor. The Second, Third, Sixth, Eighth and Tenth Circuits have broadly interpreted § 546(e) to shield all transfers made in connection with a securities contract from avoidance, so long as either the debtor or defendant used a bank account to make or receive the transfer. These courts have given precedence to the policy of protecting securities transactions. Conversely, the Seventh and Eleventh Circuits have more narrowly interpreted the safe harbor in an attempt to harmonize § 546(e) with the remainder of chapter 5, as well as to balance the competing policy interests.

Given the depth of the circuit split, if Congress does not act to clarify the statutory language, it is likely that the U.S. Supreme Court will eventually be called upon to resolve this issue. But until then, *FTI Consulting* gives bankruptcy trustees in the Seventh Circuit the ability to avoid certain transactions for the benefit of creditors that would be barred in other circuits. abi

25 *Id.* at *3.
26 *Id.* at *3-5.
27 *Bonded Fin. Servs. Inc. v. European Am. Bank*, 838 F.2d 890, 893 (7th Cir. 1988). In *Bonded*, the Seventh Circuit "found that a bank that 'acted as a financial intermediary' and 'received no benefit' was not a 'transferee' within the meaning of chapter 5 of the Bankruptcy Code." *FTI Consulting*, 2016 WL 4036408, at *5 (quoting *Bonded*, F.2d at 893).
28 *Id.*
29 *Id.* at *4-5.
30 *Id.* at *6.
31 *Id.*
32 *Id.*
33 *See Enron*, 651 F.3d at 334.