STROOCK
SPECIAL BULLETIN

Why It Pays to Read the Definitions Carefully: *Merit Management Group, LP v. FTI Consulting, Inc.*

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In its February 27, 2018 decision in *Merit Management Group, LP v. FTI Consulting, Inc.*,[1] the United States Supreme Court resolved a circuit split on the scope of the "safe harbor" defense under section 546(e) to certain avoidance actions of the United States Bankruptcy Code. Although the decision appears to limit the defense severely in certain situations, the Court's ruling was guided by the appellant's failure to argue that it (or the debtor) was a "financial institution" as that term is used in the Bankruptcy Code. This argument, which the Court noted but did not address in the *Merit* case, may well lead to a different result in other cases.

Section 546(e) provides a defense to certain avoidance actions (preferential and constructively fraudulent transfer claims) that may be brought by a bankruptcy trustee or other estate representative. This section exempts margin payments, settlement payments and other transfers from avoidance provided they were made "in connection with a securities contract" and by or to (or for the benefit of) certain protected parties, including stockbrokers, securities clearing agencies and financial institutions, as those terms are defined in the Bankruptcy Code.

Merit involved a purchase of stock in a privately-held company. When the purchaser became bankrupt, its litigation trustee brought a fraudulent conveyance action against the selling shareholder, claiming the purchaser was insolvent when it "significantly overpaid" for the stock prior to the bankruptcy. The defendant argued that the transfer was protected under section 546(e), due to the presence of "financial institutions" in the transaction – the purchase price was transferred by the purchaser's bank lender to another bank acting as escrow agent. According to the defendant, the ultimate transfer to Merit could not be avoided because it necessarily involved the transfer of the purchase price between financial institutions, shielding the entire transaction from avoidance.

The Seventh Circuit Court of Appeals disagreed, concluding that Section 546(e) did not apply where the financial institution acted merely as a

[1] *Merit Management Group, LP v. FTI Consulting, Inc.*, No. 16–784, 538 U.S. __ (February 27, 2018) ("Slip Opinion").

conduit.[2] The Supreme Court affirmed, concluding that the plain language of section 546(e) required the court to consider the "overarching" transfer from the debtor to Merit that the trustee sought to avoid, rather than focusing on each component part of the transfer. Thus, in applying the safe harbor protections, a transfer between two otherwise non-protected parties does not fall into the safe harbor merely due to the presence of a protected party fulfilling an intermediary role in the transaction, and the component transfers between those intermediaries are simply irrelevant.[3]

Perhaps the most interesting aspect of the case is that the appellant missed a statutory argument that may well have led to a different result. Section 101(22)(A) of the Bankruptcy Code defines "financial institution" (one of the protected parties under section 546(e)) as-

> a Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity **and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer** (whether or not a "customer", as defined in section 741) in connection with a securities contract (as defined in section 741) **such customer.**[4]

Thus, where one of the listed financial institutions is acting as agent or custodian for a customer, the customer is itself a protected "financial institution."

The Supreme Court was keenly aware of this argument, as well as appellant's failure to raise it.

> The parties here do not contend that either the debtor or petitioner in this case qualified as a 'financial institution' by virtue of its status as a 'customer' under §101(22)(A). Petitioner Merit Management Group, LP, discussed this definition only in footnotes and did not argue that it somehow dictates the outcome in this case. We therefore do not address what impact, if any, §101(22)(A) would have in the application of the §546(e) safe harbor.[5]

Therefore, the Court concluded that "[b]ecause the parties do not contend that either Valley View or Merit is a 'financial institution' or other covered entity, the transfer falls outside of the §546(e) safe harbor."[6]

The impact of the *Merit* decision may therefore be limited. By linking its holding to the failure of the parties to make an argument based on section 101(22)(A), the Supreme Court has left this issue open to be litigated in future cases. In many securities transactions involving a financial institution as intermediary, the transferor or the end recipient could itself be a financial institution in its capacity as a customer of the intermediary, so that (consistent with the *Merit* ruling) the overarching transfer sought to be avoided would be a transfer by or to (or for the benefit of) such customer, and therefore not be subject to avoidance.

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[2] *See FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690, 691 (7th Cir. 2016). The contrary circuit court decisions are cited in the Slip Opinion. at 9, n.6.

[3] *See* Slip Opinion at 11-14.

[4] 11 U.S.C. §101(22)(A) (emphasis added).

[5] Slip Opinion at 5-6, n.2 (internal citations omitted).

[6] Slip Opinion at 19.

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