BURR ALERT

Payments on Commercial Mortgage-Backed Securities Loans Cannot be Avoided in Bankruptcy

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The Bankruptcy Code gives a trustee the power to avoid pre-petition fraudulent and preference transfers made by a debtor, except that a trustee may not avoid a transfer that is "made by or to (or for the benefit of)" a party enumerated in § 546(e) of the Code "in connection with a securities contract."[1] Although § 546(e) has been applied in various circumstances, there is little court guidance on whether § 546(e) protects transfers made to repay commercial mortgage-backed securities ("CMBS") loans. One case in particular has applied § 546(e) to dismiss such an avoidance action: *Krol v. Key Bank Nat'l Ass'n (In re MCK Millennium Centre Parking, LLC)*, 532 B.R. 716 (Bankr. N.D. Ill. 2015).

Section 546(e)

In determining which transfers fall under § 546(e), circuit courts have taken either a broad approach or a narrow approach.[2] A majority of circuit courts have applied a broad approach, finding that the plain language of the Code does not expressly require a specific type of transfer or interest obtained by a party enumerated under § 546(e), and that any participation by an enumerated party is sufficient to protect the transaction.[3] In particular, the Second Circuit has found that "the language of Section 546(e) covers all transfers by or to financial intermediaries that are 'settlement payment[s]' or 'in connection with a securities contract.'"[4] "Transfers in which either the transferor or transferee is not such an intermediary are clearly included in the language" because § 546(e) is meant to protect the transaction and not just the entities involved in the transaction.[5] Therefore, under the broad approach the analysis hinges on whether the transfer itself is included in the language of § 546(e) rather than focusing on whether the transferor or transferee is a financial intermediary.[6]

A minority of courts have taken a more narrow approach, holding that transfers are not protected under § 546(e) unless a party enumerated in the statute is the "transferee" that acquired a

[1] 11 U.S.C. §§ 544, 546(e), 547, 548, and 550.

[2] *See FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690 (7th Cir. 2016); *In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98 (2d Cir. 2016); *Munford v. Valuation Research Corp. (In re Munford)*, 98 F.3d 604, 610 (11th Cir. 1996).

[3] *In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d at 112 (finding that the focus of the analysis should not be on the status of a party as a financial intermediary but instead on the transaction itself); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 551 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986-87 (8th Cir. 2009); *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 516 (3d Cir. 1999); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1240 (10th Cir. 1991).

[4] *In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d at 112.

[5] *Id.* at 121.

[6] *Id.*

beneficial interest in the transferred property.[7] The Eleventh Circuit's decision in *Munford* set the framework for the minority approach.[8] Since *Munford*, Congress amended § 546(e) to include the language "(or for the benefit of)."[9] In July 2016, the Seventh Circuit issued an opinion adopting *Munford* and reaffirming the pre-2006 approach despite the added language.[10] In rendering its opinion, the Seventh Circuit disregarded the 2006 amendment as inconsequential, stating that "Congress would not have jettisoned *Munford*'s rule by such a subtle and circuitous route."[11] Other courts have distinguished *Munford*, finding that Congress did enough to differentiate a transfer "for the benefit of" from a transfer made "by or to."[12] As a result, those courts found that a transfer can be made for the benefit of an enumerated party, but not necessarily "to" that party, and still be protected under § 546(e).[13] As the application of § 546(e) varies across circuits, it is essential to recognize how each approach would apply in the context of CMBS loans.

CMBS Loans

To understand how § 546(e) applies in the context of CMBS loans, it is important to understand how they function, including the roles of parties acting on behalf of the securitized trust. Traditionally, under the securitization process "lenders transfer mortgage loans into a single pool or trust."[14] After the loans are transferred to the trust, certificates generally are sold "entitling the holders to payments from principal and interest on [the] large pool of mortgages."[15]

This type of securitization is typically memorialized in a pooling and servicing agreement ("PSA"), which "is an agreement creating a trust that defines the terms under which promissory notes and their related mortgages are placed into a trust, describes how the notes and mortgages and related loan documents are transferred by and between the parties to the trust, and sets forth the various responsibilities of the parties to the trust."[16] Traditionally, such a trust is managed by a master servicer that handles the day-to-day loan administration functions and services the loans.[17]

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[7] *See FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d at 690; *In re Munford*, 98 F.3d at 610 (holding that a party that was an intermediary or conduit was not protected by § 546(e) because the transfer was not made by or to the party).

[8] *In re Munford*, 98 F.3d at 610.

[9] *Parcside Equity v. Menotte (In re CLSF III IV, Inc.)*, Ch. 7 Case No. 12-30081-EPK, Adv. Pro. No. 13-01479-EPK, slip op. at 12 (Bankr. S.D. Fla. Sept. 11, 2015).

[10] *FTI Consulting, Inc.*, 830 F.3d at 690.

[11] *Id.* at 697.

[12] *Parcside Equity*, slip op. at 12; *see also In re D.E.I. Sys., Inc.*, 996 F. Supp. 2d 1142, 1150 (D. Utah 2014) ("[S]tandard rules of construction require the phrase 'made by or to' must mean something different than 'for the benefit of.' Since 'for the benefit of' embraces a beneficial interest in the securities, 'made by or to' cannot be read to include that requirement.").

[13] *Id.*

[14] *In re Walker*, 466 B.R. 271, 274 n.2 (Bankr. E.D. Penn. 2012).

[15] *In re MCK Millennium Centre Parking, LLC*, 532 B.R. at 729.

[16] *In re Smoak*, 461 B.R. 510, 515 (Bankr. S.D. Ohio 2011).

[17] *In re MCK Millennium Centre Parking, LLC*, 532 B.R. at 729 (citing *In re General Growth Properties, Inc.*, 409 B.R. 43, 51 (Bankr. S.D.N.Y. 2009)).

In re MCK Millennium

The United States Bankruptcy Court for the Northern District of Illinois in *In re MCK Millennium*, has analyzed § 546(e) in the context of a CMBS loan.[18] The court went through a two-part analysis to determine whether a transfer made to a master servicer of a CMBS loan, who held the funds temporarily before transferring them to a securitized trust, would be a protected transfer under § 546(e).[19]

First, the court looked at whether the transfers were made "by or to" a party enumerated under the statute.[20] The master servicer under the PSA was a commercial bank, which is included within the Code's definition of a "financial institution," an enumerated party under § 546(e).[21] The more complicated question the court had to answer was whether the transfer was made "to" the bank.[22] The court recognized the split among circuits in addressing whether payments made to financial institutions that act as an intermediary for avoidable transfers are "transferees" under the statute.[23] The court found that the language "by or to" was clear and held that payments made either by or to a financial institution without any beneficial interest in the payments, such as the master servicer of a CMBS loan, can still be protected under § 546(e).[24]

Second, the court looked at whether the transfer was made "in connection with a securities contract."[25] "[T]he term 'securities contract' expansively includes contracts for the purchase or sale of securities, as well as any agreements that are similar or related to contracts for the purchase or sale of securities."[26] The court found that although the CMBS loan payment is a two-tiered transaction, it fit within the definition of a securities contract under § 741(7)(A) because the integration of the loan with the PSA and the subsequent sale of certificates under the PSA representing investors' interests in the loan sufficiently relates the loan to the PSA, which is a contract for the purchase and sale of securities.[27] Additionally, the court found that the payments were made "in connection with" because that term should be broadly interpreted to include payments related to a security agreement, particularly payments made in relation to a PSA.[28]

The Seventh Circuit's subsequent decision in *FTI Consulting, Inc.* chips away at the analysis in *In re MCK Millennium* regarding whether a transfer is made "by or to" an enumerated party. The Seventh Circuit held that payments are not made "by or to" an enumerated party unless the enumerated party is a transferee that acquired a beneficial interest in the transferred property.[29] The bankruptcy court's first part of the analysis in *In re MCK Millennium* may have been abrogated by the Seventh Circuit's decision in *FTI Consulting, Inc.* because the bankruptcy court found that

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[18] *Id.* at 729.
[19] *Id.*
[20] *Id.*
[21] 11 U.S.C. § 546(e); 11 U.S.C. § 101(22)(A).
[22] *In re MCK Millennium Centre Parking, LLC*, 532 B.R. at 729.
[23] *Id.* at 728.
[24] *Id.*
[25] *Id.* at 730.
[26] *Id.* at 728-729 (quoting *In re Madoff Inv. Sec., LLC*, 773 F.3d 411, 418 (2d Cir. 2014)).
[27] *Id.* at 730.
[28] *Id.* at 731.
[29] *FTI Consulting, Inc.*, 830 F.3d at 690.

the master servicer did not obtain a beneficial interest in the payments. However, if the beneficial interest of the payments is held in the securitized trust, which holds legal title to the payments under the traditional PSA, the securitized trust, and not the master servicer, may be the "transferee" that acquired the beneficial interest.[30] If the securitized trust is both the "transferee" and a party enumerated under § 546(e), payments made on the CMBS loan may still be protected, even in the Seventh Circuit.

Despite the fact that the Seventh Circuit has a narrow view of what made "by or to" means, *In re MCK Millennium* is still persuasive authority for whether payments made on a CMBS loan can be made "in connection with a securities contract" as defined in § 546(e). Additionally, if the facts in *In re MCK Millennium* are revisited, different arguments regarding the identity of the "transferee," which may include the securitized trust or trustee under the PSA, can be made to prevent the trustee from avoiding and recovering payments made on a CMBS loan. A party may argue that the transfer is still protected if the securitized trust is an enumerated party because the transfer was made "by or to" an enumerated party as the securitized trust received the benefit of the transfer. The court *In re MCK Millennium* did not need to address these arguments because the transfer was already protected under the broad approach, which was later rejected by the Seventh Circuit in *FTI Consulting, Inc.* However, whether analyzed under the narrow or broad approach, § 546(e) should protect payments made on a CMBS loan.

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[30] *See Bonded Financial Services, Inc., v. European American Bank*, 838 F.2d 890, 893 (7th Cir. 1988) (holding that an initial transferee must at a minimum have "dominion over the money or other assets, the right to put the money to one's own purposes").