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Supreme Court Limits the Scope of Bankruptcy Code's Safe Harbors

In a decision with implications for leveraged buyouts and other financial transactions, the U.S. Supreme Court yesterday resolved a split in authority by adopting the narrower of two readings of the Bankruptcy Code's "safe harbors." The Bankruptcy Code allows certain pre-bankruptcy transfers by a debtor to be "avoided" and recovered for the benefit of creditors, but establishes safe harbors to shield various financial-market transactions from avoidance. One safe harbor, section 546(e), protects "settlement payments" and transfers in connection with a "securities contract," if made "by or to (or for the benefit of)" a "financial institution" or other specified market participants.

In *Merit Management Group, LP* v. *FTI Consulting, Inc.*, Valley View Downs borrowed money from Credit Suisse to acquire the stock of Bedford Downs, a competitor. An escrow agent, Citizens Bank of Pennsylvania, received funds from Credit Suisse, and then distributed stock to Valley View and cash to shareholders of Bedford Downs. After Valley View filed for bankruptcy, FTI Consulting, a court-appointed trustee, sued Merit Management, a Bedford Downs shareholder, to avoid payments Merit Management received in the sale.

The bankruptcy court held that the safe harbor protected the transfer, because it involved payment for securities *by* a financial institution — Credit Suisse — *to* another financial institution — Citizens Bank, but the Seventh Circuit reversed. A unanimous Supreme Court agreed with the Seventh Circuit, concluding that, in applying the safe harbor, the court should analyze the "overarching transfer" that the trustee seeks to avoid, rather than any component transactions among intermediaries. Because FTI Consulting sought to avoid the overarching transfer from Valley View to Merit Management, the component transactions (from Credit Suisse to Citizens Bank and from Citizens Bank to Merit Management) did not matter. And because neither Valley View nor Merit Management claimed to be financial institutions, the transfer was not by or to a financial institution, so the safe harbor did not apply.

Prior to *Merit Management*, many courts applied the safe harbors to financial transactions, including payments to shareholders in an LBO, based on the involvement of financial institution intermediaries. After *Merit Management*, the presence of such intermediaries will not suffice to invoke safe harbor protection, increasing the risk of later bankruptcy litigation challenging such transactions.

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