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Justices Hone Creditors' Ability To Ax Pre-Bankruptcy Deals

By **Alex Wolf**

Law360 (February 28, 2018, 10:06 PM EST) -- The U.S. Supreme Court has opened the door for creditors to claw back more funds in bankruptcy by rejecting the notion that a securities transaction can be insulated from avoidance actions as long as it involved a financial institution, even as just a conduit in a deal, experts say.

In a unanimous decision Tuesday, the high court resolved a circuit split over the scope of the Bankruptcy Code's "safe harbor" provision exempting certain transactions from clawbacks, concluding that a transfer can be undone in bankruptcy if funds simply move through a financial institution without benefiting it. The justices found that when determining whether fraudulent transfers can be undone in bankruptcy, courts should look at the overarching exchange instead of its component parts.

By enshrining a limitation to the scope of safe harbor, often used to shield prepetition transfers from being targeted in bankruptcy, the Supreme Court has given trustees and estate representatives a clearer path to bring creditor claims and claw back funds used to facilitate a merger, acquisition or other transaction, attorneys say.

"Obviously this is good news for trustees and anyone else who's acting as a plaintiff in clawback actions and bad news for defendants," said Kleinberg Kaplan Wolff & Cohen PC attorney Matthew Gold. "The threat of litigation will be more of a cloud that people will at least have to consider."

At hand in the case is a dispute over whether the Seventh Circuit correctly interpreted Section 546(e) of the Bankruptcy Code to allow the Chapter 11 trustee of a bankrupt gambling company to recover a portion of money it paid to purchase a rival Pennsylvania racetrack and casino operator. Specifically, the trustee sought to claw back $16.5 million from Merit Management Group LP for its interest in the $55 million transaction.

Merit had argued that the safe harbor rule applies to transfers where financial institutions serve as intermediaries, not just in cases where the institution directly benefits from the transfer. Since the purchase went through Credit Suisse AG and Citizens Bank of Pennsylvania acting as lender and escrow agent, the transaction should be immune to any efforts to undo it in bankruptcy, Merit contended.

Aligning itself with a unanimous panel for the Seventh Circuit, the Supreme Court shut down Merit's challenge, ruling that the safe harbor provision can't be used to protect transfers that were made through a bank but didn't involve the bank as a direct party. In simple terms, the rule "dictates that the only relevant

transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid," the justices said.

For creditors that may seek to undo a leveraged buyout or other transfer that perhaps unfairly siphoned away funds from a debtor before bankruptcy, there has long been a concern that the parties that benefited from the exchange could be shielded from avoidance claims if a financial institution was involved at some point in the transactional chain, Cooley LLP partner Jay Indyke said, adding that safe harbor has in some cases come in the way of a "really good claim against parties."

But with the Supreme Court's decision now on the books, more parties will have to defend cases on the merits rather than relying on a technicality that was getting them off the hook, Indyke said.

"It's going to have an impact on recoveries and how those actions move forward, and you might see a lot more aggression on the side of plaintiffs with respect to potential claims," he said. "To a certain extent, there could be a feeling that the balance of the scales shifted more equitably."

According to University of Chicago Law School professor Douglas G. Baird, the shift generated by the ruling is necessary in light of what he sees as an unchecked and growing use of safe harbors weakening fraudulent conveyance actions.

"There has been a concern over time that if you didn't do something about it, these exceptions would gut fraudulent conveyance law," he said. "Essentially, these safe harbors have metastasized throughout the Bankruptcy Code."

With their decision, the justices have effectively tossed out standing interpretations of the safe harbor rule held by the Second, Third, Sixth, Eighth and Tenth circuits.

But while attorneys agree the decision creates more opportunities for bankrupt estates to recover fraudulent transfers, several say the court's calculated focus on the scope of safe harbor should bring a sense of relief to those who fretted over whether it would limit what can be considered a "financial institution."

"With a statute like this, where there are a lot of moving parts, it might be easy for a court to make a ruling like this that gets way over-interpreted," Mayer Brown LLP attorney Joshua Yount said. "But I think the Supreme Court was careful to say, 'We're not deciding all issues under the statute.'"

Stephen Newman of Stroock & Stroock & Lavan LLP noted that the opinion should also ease concerns that the court would drastically strip down safe harbor provisions, opening the door to even more potential clawback litigation.

By focusing on the particular facts in the instant case, the ruling appears to leave in place all of the protections for passive shareholders who may receive settlement payments in connection to a securities contract, he said.

Indeed, the justices' straightforward explanation of the issues should provide a sense of relief for the broader securities market, and make it easier for parties to apply going forward, said Jeanne P. Darcey of Sullivan & Worcester LLP.

"With this ruling, you're just going to look at the overall transfer rather than all of these component parts," she said.

Merit is represented by Brian C. Walsh, Jason J. DeJonker, Justin A. Morgan, John Schoemehl and Leslie A. Bayles of Bryan Cave LLP.

FTI is represented by Paul D. Clement, H. Christopher Bartolomucci and George W. Hicks of Kirkland & Ellis LLP, and William T. Reid IV, Gregory Schwegmann and Josh Bruckerhoff of Reid Collins & Tsai LLP.

The case is Merit Management Group LP v. FTI Consulting Inc., case number 16-784, in the Supreme Court of the United States.

--Editing by Aaron Pelc.

Correction: A previous version of this story incorrectly spelled an attorney's name. The error has been corrected.
