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Bankruptcy Safe Harbors Are Not Necessarily Safe for Financial Institution Customers

Scott A. Lewis and Franklin H. Top III*

The authors of this article explain a recent bankruptcy court decision, which expressed reservations about a decision by the U.S. Court of Appeals for the Second Circuit regarding when transfers to financial institutions' customers that are settlement payments or made in connection with securities contracts are entitled to protection from avoidance actions under the bankruptcy safe harbors.

The U.S. Bankruptcy Court for the Eastern District of Michigan has expressed reservations about the decision by the U.S. Court of Appeals for the Second Circuit in *In re Tribune Co. Fraudulent Conveyance Litigation* ("*In re Tribune Co.*"),[1] regarding when transfers to financial institutions' customers that are (i) settlement payments, or (ii) made in connection with securities contracts are entitled to protection from avoidance actions under the bankruptcy safe harbors.[2] The bankruptcy court heard the matter on remand from the U.S. Court of Appeals for the Sixth Circuit due to the U.S. Supreme Court's recent decision in *Merit Management Grp. LP v. FTI Consulting, Inc.* ("*Merit*"),[3] which abrogated relevant Sixth Circuit precedent.

The bankruptcy court's determination is important because *In re Tribune Co.* interpreted the protections of 11 U.S.C. § 546(e) broadly to protect most transfers of settlement payments or payments made otherwise in connection with securities contracts to financial institutions' customers from avoidance actions initiated under Chapter 5 of the U.S. Bankruptcy Code. The bankruptcy court, however, applied a more rigorous analysis that limits the scope of 11 U.S.C. § 546(e).

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[1] 946 F.3d 66 (2d Cir. 2019).

[2] *Buchwald Capital Advisors, LLC v. Papas* (*In re Greektown Holdings, LLC*), 621 B.R. 797 (Bankr. E.D. Mich. 2020) ("*Buchwald*").

[3] 138 S. Ct. 883 (2018).

BACKGROUND

Section 546(e) of the Bankruptcy Code protects transfers made by or to (or for the benefit of) a financial institution that are settlement payments[4] or in connection with a securities contract[5] from most avoidance actions under the Bankruptcy Code, including actions for preference and constructive fraudulent transfer. The Supreme Court recently addressed 11 U.S.C. § 546(e) in connection with the purchase by one corporation of all of the issued and outstanding shares of another, and resolved a split among the circuits by holding that the only relevant transfer for purposes of 11 U.S.C. § 546(e) is the transfer that the bankruptcy trustee seeks to avoid, not intermediate transfers made to financial institutions or otherwise to effect the overarching transfer.

In *Merit*, the transfers sought to be avoided were payments made by the debtor (the pre-petition purchaser) to the stockholders of the purchased company, which payments were passed from the debtor to the stockholders through financial institutions. Provided a bankruptcy trustee properly identifies a transfer for avoidance, the beneficiaries of the transfer are not entitled to the protections of 11 U.S.C. § 546(e) solely because the transfer flowed through financial institutions, according to the *Merit* decision. Thus, after *Merit*, channeling settlement payments and transfers in connection with securities contracts to non-financial institutions through financial-institution intermediaries generally does not protect non-financial institution beneficiaries from avoidance actions initiated under the Bankruptcy Code.

The bankruptcy court (and the Second Circuit in *In re Tribune*), however, decided an issue left open by the Supreme Court. In *Merit*, the Supreme Court expressly noted that the parties in the case had not contended that either the debtor or the petitioner was a "financial institution" by virtue of its status as a financial-institution customer under 11 U.S.C. § 101(22)(A) and thus entitled to the protection of 11 U.S.C. § 546(e) upon such grounds.[6]

Under 11 U.S.C. § 101(22)(A), a financial institution that is acting as an agent or a custodian for a customer in connection with a securities contract transforms the customer into a financial institution within the meaning of the

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[4] "The term 'settlement payment' is interpreted broadly under case law to encompass most transfers of money or securities to complete a securities transaction." *Buchwald*, *supra* note 2 (citations omitted); *see also* 11 U.S.C. § 741(8) (defining "settlement payment").

[5] 11 U. S.C. § 741(7) (defining a "securities contract," in part, to mean "a contract for the purchase, sale, or loan of a security. . . ."); *see also* 11 U.S.C. § 101(49) (defining the term "security" to include, among other assets, a note).

[6] *Merit*, *supra* note 3 at 890 n.2.

Bankruptcy Code (and thus the customer becomes independently eligible for the protections of 11 U.S.C. § 546(e) for transfers involving settlement payments or in connection with securities contracts). In *In re Tribune Co*., the Second Circuit interpreted the term "agent" in 11 U.S.C. § 101(22)(A) expansively and seemingly held that a financial institution acts as an agent for its customer within the meaning of 11 U.S.C. § 101(22)(a) when the financial institution transfers funds as part of a securities transaction and effectuates the transaction.

Such broad interpretation acts as a "complete workaround" of the *Merit* decision, according to the bankruptcy court.[7] Under the analysis of *In re Tribune Co.*, most any financial-institution intermediary hired to transfer funds and effectuate a transaction may qualify as a customer's agent such that the customer would be entitled, independently, to the protections of 11 U.S.C. § 546(e). The bankruptcy court took a different approach.

BANKRUPTCY COURT'S ANALYSIS

Facts of the Case

Two individual defendants (the "Defendants") owned approximately 86 percent of the ownership interests in Monroe Partners, LLC (*"Monroe"*), which. in turn, owned a 50 percent interest in Greektown Casino, LLC ("Greektown Casino"). The other 50 percent of Greektown Casino was owned by Kewadin Greektown Casino, LLC ("Kewadin"). In July 2000, the Defendants and Monroe entered into an agreement wherein Monroe purchased and redeemed the Defendants' membership interests in Monroe in exchange for future installment payments. On the same date, Kewadin became the owner of equivalent membership interests in Monroe and obligated itself to make the installment payments to the Defendants. The installments were made for a period of time. In 2005, the parties entered into a series of agreements that provided for a settlement and payment of the balance owing to the Defendants in the amount of $150 million (the "2005 Transaction").

The monies to be used to pay the Defendants were obtained from a reorganization of Greektown Casino's corporate and financial structure. In connection therewith, Monroe and Kewadin incorporated Greektown Holdings, LLC (the "Debtor"), and both Monroe and Kewadin transferred all their interests in Greektown Casino to the Debtor. Further, among other actions taken, (a) the Debtor issued $182 million in unsecured senior notes (the "Senior Notes") to be purchased by Merrill Lynch, Pierce, Fenner & Smith Inc.

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[7] *Buchwald*, *supra* note 2. *In re Tribune Co.* was decided after *Merit.*

(the "Underwriter"); (b) the Underwriter sold the Senior Notes to institutional purchasers; and (c) the net sale proceeds of the Senior Notes were used primarily to make the agreed-upon payments to the Defendants.[8]

In December 2005, the Debtor issued the Senior Notes to the Underwriter and made the indicated payments to the Defendants by wire transfer from the Underwriter to the Defendants' bank accounts with Chase Manhattan Bank and Comerica Bank (the "Wire Payments").[9] In May 2008, the Debtor, Greektown Casino, Monroe, Kewadin and other related entities filed Chapter 11 bankruptcies.

Bankruptcy Court's Analysis on Remand

The bankruptcy court, on remand from the Sixth Circuit for consideration of the *Merit* decision, disagreed with the ruling of the prior bankruptcy court (the "prior court") that 11 U.S.C. § 546(e) protected the transfer of monies to the Defendants in connection with the 2005 Transaction from avoidance as constructive fraudulent transfers, which was affirmed by the district court, and denied the Defendants' motion for summary judgment.[10] The bankruptcy court held that the transfer of the Senior Note proceeds to the Defendants was not protected from avoidance by 11 U.S.C. § 546(e).

In making its decision, the bankruptcy court considered the following issues: (1) what was the relevant transfer for purposes of applying 11 U.S.C. § 546(e); (2) whether the 2005 Transaction was for the Underwriter's benefit; and (3) whether the Debtor can itself be deemed a financial institution within the meaning of the Bankruptcy Code.[11] The bankruptcy court, however, otherwise adopted the prior court's findings and conclusions, including that (A) the Underwriter was a financial institution within the meaning of 11 U.S.C. § 101(22)(A); (B) the challenged transfer was a settlement payment within the meaning of the Bankruptcy Code; and (C) the transfer was made in connection with a securities contract.[12]

The Relevant Transfer

In consideration of the *Merit* decision, the Defendants first argued to the bankruptcy court that the transfer that should be subject to the 11 U.S.C.

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[8] $170 million in total was paid to the Defendants from the net proceeds of the notes.

[9] Certain agreements and transfers in connection with the 2005 Transaction were made by Merrill Lynch Capital Corporation rather than Merrill Lynch, Pierce, Fenner & Smith Inc. However, for simplicity, we use only the term the Underwriter herein.

[10] Pending appeal to the Sixth Circuit, the *Merit* decision was issued.

[11] *Buchwald*, *supra* note 2.

[12] *Id.*

§ 546(e) analysis was the transfer of the Senior Note proceeds to the Defendants by the Underwriter, with the Debtor being a mere conduit. The bankruptcy court found this explanation to be disingenuous, as the record showed that there was no dispute that the transfer at issue was of the Debtor's property.[13] The bankruptcy court noted that, according to the *Merit* decision, the relevant transaction to which 11 U.S.C. § 546(e) should be applied was the overarching transfer the bankruptcy trustee sought to avoid, which was the transfer from the Debtor to the Defendants of the Senior Note proceeds.[14]

Component parts of the transfer, including the intermediate transfers involving the Underwriter, Chase Manhattan Bank and Comerica Bank, were not relevant to the 11 U.S.C. § 546(e) analysis, according to the *Merit* decision.[15] The mere fact that the Underwriter was a financial institution and had some role in the overarching transaction was insufficient to entitle the Defendants to the protections of 11 U.S.C. § 546.[16]

Whether the 2005 Transaction Was for the Underwriter's Benefit

The Defendants next argued that the 2005 Transaction was "for the benefit" of the Underwriter such that the relevant transfer to the Defendants would be protected from avoidance under 11 U.S.C. § 546(e).[17] The Defendants pointed out that the Underwriter had many roles in the 2005 Transaction, including serving as underwriter, initial purchaser of the Senior Notes, agent for the other purchasers to the Senior Notes, recipient of note proceeds, exchange agent, and disbursing bank.[18] The Underwriter also realized substantial fees and related compensation from the sale of the notes.[19] The bankruptcy court, however, noted that the *Merit* decision explained that the addition of the phrase "for the benefit of" to 11 U.S.C. § 546(e) was to ensure the scope of the safe harbor matched the scope of the avoiding powers.[20]

The bankruptcy court concluded that the Defendants must establish that the Underwriter received a "direct, ascertainable, and quantifiable benefit corresponding in value to the payments to Defendants" for the 2005 Transaction to

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] Neither party disputed that the Debtor and the Defendants were not financial institutions in their own right under the Bankruptcy Code.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

be "for the benefit" of the Underwriter and the transfer to the Defendants thus to be entitled to the protections of 11 U.S.C. § 546(e) on such grounds.[21] The bankruptcy court noted that the Underwriter received several millions of dollars in fees and expenses generated out of the note sale and new credit facility under the 2005 Transaction, but the bankruptcy court found those amounts insufficient to establish that the 2005 Transaction was "for the benefit of" the Underwriter.[22] The fees, the court noted, were incidental to the 2005 Transaction and did not correspond in value to the transfer to the Defendants.[23]

Is the Debtor Deemed to Be a Financial Institution Under the Bankruptcy Code?

The Defendants' third basis for relief was that the Debtor, independently, was deemed by 11 U.S.C. § 101(22)(A) to be a "financial institution" because the Underwriter was acting as an agent or custodian for its customer, the Debtor, when transferring the Senior Note proceeds and thus the transfer was "by" a financial institution entitled to the protection of 11 U.S.C. § 546(e).[24] Specifically, the Defendants asserted that the Underwriter was acting as an agent for the Debtor when performing as the underwriter for the Senior Notes and as disbursing agent with respect to the 2005 Transaction.[25] The Bankruptcy Code does not define the term "agent," so the bankruptcy court relied upon general common-law definitions to interpret the term.[26] The bankruptcy court mainly looked to the Restatement (Third) of Agency and noted: "[m]any actors perform an intermediary role between parties who engage in transactions. Not all are agents . . . ."[27] It indicated that an agency relationship creates fiduciary duties.[28] The bankruptcy court determined that to prove agency, the Defendants must establish that:

> (1) [the Debtor] manifested assent to [the Underwriter] that [the Underwriter] shall act on [the Debtor's] behalf; (2) subject to [the

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[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.* The parties disputed whether or not federal or Michigan common law should be consulted. The bankruptcy court, however, noted that cases under federal and Michigan common law cited the Restatement (Third) of Agency § 1.01 (2006).

[27] *Id.* (Citing Commentary to Restatement (Third) of Agency § 1.01 (2006)).

[28] *Id.*

> Debtor's] control; and (3) [the Underwriter] manifest assent or otherwise consented so to act.[[29]]

The bankruptcy court also noted that "to act on the [Debtor's] behalf" meant to be a "business representative" of the Debtor with the ability "to bring about, modify, affect, accept performance of, or terminate contractual obligations between [the Debtor] and third persons."[30]

The existence of an agency relationship generally is a question of fact.[31] Labels are not determinative. The bankruptcy court, however, looked to the language of the agreements that supported the 2005 Transaction. After review thereof, the bankruptcy court concluded that the Underwriter was merely authorized to perform contractual services.[32] The agreements did not establish that the Underwriter was a "business representative" of the Debtor or "could 'bring about, modify, affect, accept performance of, or terminate contractual obligations between [the Debtor] and third persons.' "[33] Thus, the Defendants failed to prove the initial element of agency.[34] The Underwriter was not acting as an agent for the Debtor in making the transfer to the Defendants, the bankruptcy court held.

Next, with respect to whether the Underwriter was acting as a "custodian" for the benefit of the Debtor, 11 U.S.C. § 101(11)(C) defines the term "custodian" in pertinent part as a trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.

The bankruptcy court noted that it had already held that the Underwriter was not an agent and the parties did not argue that it was a trustee or receiver.[35] Further, no evidence was presented that Defendants had a lien on the Senior Note proceeds.[36] The Defendants were creditors of the Debtor's parent

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.* (citation omitted).

[34] *Id.*

[35] *Id.*

[36] *Id.*

companies, not of the Debtor.[37] Evidence was not presented that the Underwriter was acting for the purpose of general administration of such property for the benefit of all the Debtor's creditors.[38] The bankruptcy court thus also found that the Underwriter was not acting as a custodian for the Debtor in making the transfer. The Underwriter was not the agent or custodian of the Debtor, and the Defendants were not entitled to the protections of 11 U.S.C. § 546(e) upon such grounds.

CONCLUSION

The *Merit* decision had ruled that the overarching transfer that the bankruptcy trustee sought to avoid is the relevant transfer for purposes of 11 U.S.C. § 546(e), so long as it is properly identified. Intermediate transfers are not relevant such that routing transfers through intervening financial institutions should not entitle the transfer's beneficiaries to the protections of 11 U.S.C. § 546(e).

The Second Circuit's decision in *In re Tribune Co.*, however, had effectively provided a workaround to the *Merit* decision whereby apparently most any financial-institution intermediary hired to transfer funds and effectuate a securities transaction transformed the beneficiaries of settlement payments and transfers in connection with securities contracts into financial institutions pursuant to 11 U.S.C.§ 101(22)(A) and entitled them to the protections of 11 U.S.C. § 546(e).

The *Buchwald* decision, however, injects new life into *Merit*. Parties thus should take care to structure transfers to non-financial institution beneficiaries under securities contract transactions carefully to be entitled to the avoidance action protections afforded under 11 U.S.C. § 546(e).

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[37] *Id.*

[38] *Id.*