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Split Second Circuit Narrows Bankruptcy Code's Settlement Payment Safe Harbor

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Two streams of payments to shareholders in a leveraged buyout (LBO), totaling $4 million (Certificate Transfers) and $1.101 billion (DTC Transfers), made through a paying agent bank, were "safe harbored under [Bankruptcy Code §546(e), but "Payroll Transfers," totaling $78 million, made to the debtor's "directors, officers and employee shareholders through its payroll program … [were] not so shielded," from fraudulent transfer claims, held the Second Circuit in a split decision. *In re Nine West LBO Securities Litigation*, 2023 WL 8180356, *4 (2d Cir. Nov. 27, 2023) (2-1). The majority opinion turned on "the scope of the term 'financial institution' as defined in [Code] §101(22)(A)" when applied to the paying agent bank and its customer, the debtor here. Id. In the majority's view, "the definition encompasses bank customers [i.e., the debtor] only in transactions with the bank acting as their agent …." *Id*.

Statutory Background

Code §546(e) bars a bankruptcy trustee's "avoidance of 'settlement payment[s] … made by or to (or for the benefit of) a … financial institution, … or … transfer[s] made by or to (or for the benefit of) a… financial institution … in connection with a securities contract …." Most important here, the "Code defines 'financial institution' to include not only banks, *but also a customer of a bank 'when [the bank] is acting as agent or custodian for a customer … in connection with a securities contract*." *Id*., quoting Code §101(22)(A) (emphasis added).

Relevant Precedent

The Supreme Court and the Second Circuit had previously limited the Code's safe harbor provision. *Merit Mgmt. Grp., L.P. v. FTI Consulting, Inc.*, 583 U.S. 366 (2018) and *In re Tribune Co. Fraudulent Comb. Litig. (Tribune II)*, 946 F.3d 66 (2d Cir. 2019), *cert. denied sub nom. Deutsche Bank Tr. Co. Americas, v. Robert R. McCormick Found.*, 141 S. Ct. 2552 (2021). In both cases, the courts held that "§546(e) does not "protect transfers in which financial institutions served as mere conduits.' *Tribune II*, 946 F.3d at 77. But an agency "relationship provided an 'alternative basis for finding that the payments were covered.'" *Id*. at *4, quoting Tribune II, 946 F.3d at 77. In this case, because the court held that the safe harbor of §546(e) is "an affirmative defense," the defendants had the burden of showing that all three of the relevant transfers here fell "within the safe harbor." *Id*. at *5.

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Qualifying Participant

The safe harbor would apply here only if the debtor who made the payments "was a covered entity" or "the shareholders, who ultimately received the payments, were covered entities." The debtor would be "a covered entity if it is considered a 'financial institution' under §101(22)(A)." According to the district court, because the bank here had acted "as an agent for a customer in connection with a securities contract, that customer counts as a 'financial institution'…." *Id*. at *5. It held, therefore, that the debtor was a "financial institution" and that all three transfers here were insulated by the safe harbor. According to the Second Circuit, though, the lower court failed to analyze other transfers aside from the Certificate and DTC Transfers. Instead, the district court applied a "'contract-by-contract' interpretation of §101(22)(a)," holding that the bank had to be "considered" the debtor's "agent" for every "transfer made in connection with the LBO." In short, said the Second Circuit, the district court mistakenly held that §546(e) "insulated all transfers made in connection with the LBO from avoidance, including the DTC Transfers and the Payroll Transfers." Because the bank here had "no role whatsoever" in the Payroll Transfers, the Second Circuit reversed that part of the lower court's holding, finding that "the safe harbor applies only to the Certificate and DTC Transfers." *Id*.

Transfer-By-Transfer Analysis Governs

The Court of Appeals, in rejecting the district court's "contract-by-contract" analysis, held instead that "§101(22)(A) must be interpreted using a 'transfer-by-transfer' approach based on: (1) the language of the statute, (2) the statutory structure, and (3) the purpose of the safe-harbor provision." *Id*. at *6. First, reasoned the court, the "Code defines a 'financial institution' to include a 'customer' of a bank …'when' the bank …'is *acting as agent*' for the customer 'in connection with a securities contract.' *Id*. at *6 (emphasis in text). In other words, when analyzing each transfer a court must ask whether and when the bank was "acting as agent" for its customer in a securities contract transaction. *Id*.

The district court's "contract-by-contract analysis "would lead to the absurd result of insulating every transfer made in connection with an LBO, as long as a bank served as agent for at least one transfer." *Id*. Because the bank here "had nothing to do with the $78 million in transfers paid through the payroll program," the Payroll Transfers should not have been covered by the safe harbor.

The district court's contract-by-contract interpretation, would also "undermine the avoidance powers that are so crucial to the … Code." *Id*. The district court's approach would also "limit the avoidance power even [when] it would not threaten the financial system — an expansion of the safe harbor provision likely not intended by Congress." *Id*. at *7. The "Payroll Transfers were not paid through [the bank here] and Congress's concerns about the settlement of securities transactions are not implicated." *Id*. Still, explained the court, "facts supporting the applicability of the §546(e) defense to the Certificate and DTC Transfer claims appear on the face of the complaint," and the district court properly dismissed those claims. *Id*.

No Agency Relationship With Payroll Transfers

The court rejected the defendant's argument that the bank acted as the debtor's agent during the Payroll Transfers. *Id*. at *8. Although the bank's role in cancelling the shares in the LBO may have been "unclear," the "record suggests that [the bank's role] was purely ministerial." *Id*.

But even a ministerial role, however, would not make the bank the debtor's agent "as a matter of law." *Id*. at *9. According to the court, "at this stage, it is not clear [the debtor] had any authority to control [the bank's] actions in cancelling the shares." Therefore, the bank's role as a transfer agent in the Payroll Transfers "is more accurately

understood as that of an independent contractor, not an agent, as required by §101(22)(A)." To immunize the transaction when a bank had only a ministerial role "would introduce inefficiency into the securities market" and "would incentivize 'large banks to aid and abet corporate looters' in LBOs." *Id*. at *9.

Securities Contract

The court also rejected the trustees' argument that the merger agreement in the LBO was not a "securities contract" under §546(e). Not only did the merger agreement in the LBO provide "for the cancellation of shares," but the Code's definition of "securities contract" was also extraordinarily broad so as to include a "contract for the purchase or sale of a security, including any repurchase transaction on any such security," plus "any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph." *Tribune II*, 946 3d at 81, citing Code §741(7)(A)(i), (vii). Because a settlement payment includes a "transfer of cash made to complete a securities transaction," *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de CV.*, 651 F.3d 329, 339 (2d Cir. 2011), the Certificate and DTC Transfers were made to effect the LBO. (For the sake of disclosure, the author represented the successful defendant, Alfa, in the Enron case cited by the Second Circuit.)

Preemption

The *Nine West* litigation trustee also sued the former directors and officers of the debtor for unjust enrichment because of the role they played in approving the merger leading to the LBO. Affirming the district court's holding that Code §546(e) preempted these claims because they sought the same remedy as the fraudulent transfer claims, the Second Circuit stressed that "state law claims that conflict with" the Code's safe harbor "are preempted." *Id*. at *11. This preemption, however, applied only to the Certificate and DTC Transfers because the Payroll Transfers "do not fall under the safe harbor," meaning that the unjust enrichment claims arising from these payments were not preempted. *Id*. at *11.

Dissent

The well-reasoned dissent agreed with the majority that "sections 546(e) and 101(22)(A) bar the Trustees from avoiding the payments made to shareholders via the DTC and Certificate Transfers." It disagreed, though, with the majority's interpretation of "financial institution." In its view, the "securities contract [here] makes clear that [the bank] was acting as [the debtor's] agent in connection with that contract, making it a "financial institution" under §101(22)(A). Therefore, the Payroll Transfer "payments for the Restricted Shares Transfers are properly subject to §546(e)'s safe harbor." *Id*. at *16.

Comments

- The majority was sensibly concerned with the possible structuring of LBOs by artful counsel who would use a financial institution as a "mere conduit" to exploit the Code's safe harbor. It got the message of *Tribune II* and *Merit Management*.
- Facts matter. Payments to officers, directors and other insiders will always be scrutinized by creditors, as was the case in *Nine West*. And the facts of the insider payments here stood out like the proverbial sore thumb. Why the insiders took their $78 million directly, unlike other shareholders, is baffling.
- The majority opinion reflects a practical, incremental refinement of the appellate courts' broad reading of the Code's settlement safe harbor. In the end, of the roughly $1.2 billion paid by the debtor in the LBO, only $78 million was vulnerable in *Nine West*.