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# Fraudulent Transfer Claims After Merit Management v. FTI: Implications for Safe Harbor Litigation

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Schulte Roth & Zabel

# Fraudulent Transfer Claims After *Merit Management v. FTI*: Implications for Safe Harbor Litigation

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# Agenda

- Overview of Merit Management v. FTI ("Merit Management").
- Merit's impact on other fraudulent transfer litigation.
- Practical implications for safe harbor issues in bankruptcy proceedings.
- Applicability of safe harbor defenses to claims outside bankruptcy.

# The Securities Safe Harbor Under Section 546(e)

- The automatic stay typically prevents counterparties to prepetition executory contracts from unilaterally terminating them or otherwise affecting a debtor's rights under those contracts.
- The Bankruptcy Code also permits a trustee to avoid several categories of prepetition transfers and to recover the transfer or its value. The goal of avoidance and recovery is to maximize the assets in a debtor's estate for the benefit of all creditors.
  - There are exceptions to a trustee's avoidance powers.
  - One exception is the securities safe harbor set forth in Bankruptcy Code section 546(e).
- Section 546(e) is a short but dense paragraph that sets forth limitations on a trustee's ability to avoid certain financial contracts. 11 U.S.C. §546.
  - Exhibit A to this presentation contains the text of section 546(e) of the Bankruptcy Code, and the various definitions used within the statute all in one place.

# History of Section 546(e)

- *Seligson v. New York Produce Exchange*, 394 F. Supp. 125 (S.D.N.Y. 1975).
- The safe harbors originated in sections 362(b)(6) and 764(c) of the 1978 version of the Bankruptcy Code. These new sections provided that “the trustee may not avoid a transfer that is a margin payment to or deposit with a commodity broker or forward contract merchant or is a settlement payment made by a clearing organization.”
- Between 1982 and 2006, Congress amended the section several times (and placed it in chapter 5 of the Bankruptcy Code) to cover several other financial parties and contracts.
- Defendants often assert the defense when a bankruptcy trustee seeks to recover pre-bankruptcy payments by a corporation to its shareholders in a leveraged buyout.

# How 546(e) Works

- Section 546(e) of the Bankruptcy Code provides a defense to constructive fraudulent transfers and preference claims arising out of securities transactions. The purpose is to ensure that financial markets are not unduly impacted by the bankruptcy of one financial institution.
  - See H.R. Rep. No. 97-420, at 1 (1982) ("[C]ertain protections are necessary to prevent the insolvency of one commodity or securities firm from spreading to other firms and [possibly] threatening the collapse of the affected market.").
- As the Seventh Circuit has explained, without section 546(e):

> [O]ne firm's bankruptcy could cause a domino effect as its clients could similarly default on their obligations, which in turn would trigger further bankruptcies, and so on. By preventing one large bankruptcy from rippling through the securities industry in this way, the § 546(e) safe harbor protects the market from systemic risk and allows parties in the securities industry to enter into transactions with greater confidence.

*Grede v. FCStone, LLC*, 746 F.3d 244, 252 (7th Cir. 2014).

# How 546(e) Works (cont.)

- Section 546(e) accomplishes market stability by permitting certain listed financial parties to settle certain listed transactions without worrying about running afoul of the Bankruptcy Code's automatic stay.
- To qualify for the safe harbor, a transfer must meet two requirements:
  - The **transfer** must fall within a covered category (i.e., the trustee must be seeking to avoid a transfer that is a margin payment, settlement payment, or transfer in connection with a securities contract, commodity contract, or forward contract); and
  - The **parties** making the transfer must be covered by the statute (i.e., transfer must be made by, to, or for the benefit of a protected entity (a list of which is set forth in the text of 546(e)).
- If the transfer meets both requirements, it cannot be avoided by a trustee under Sections 544, 545, 547, 548(a)(1)(b) or 548(b) of the Bankruptcy Code.

# How 546(e) Works (cont.)

- Actual Fraud Exception. Payments made with actual intent to hinder, delay, or defraud creditors under section 548(a)(1) of the Bankruptcy Code are excluded from section 546(e)'s coverage. 11 U.S.C. § 546(e)
  - *Bear Stearns Secs. Corp v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 13 n.8 (S.D.N.Y. 2007) ("§ 546(e) does not preclude avoidance if there is actual fraud under § 548(a)(1)(A), which is the provision from which the Ponzi scheme presumption is derived."), *aff'd*, 2009 U.S. App. LEXIS 11806 (2d Cir. June 2, 2009) (unpublished decision) (affirmed jury verdict in favor of defendant; jury found that defendant "had conducted itself in good faith throughout the period of the transfers in question.")
  - *see also In re Hellas Telecommunications (Luxembourg) II SCA*, 2015 WL 1029921 (Bankr. S.D.N.Y. Mar. 9, 2015) (held, unjust enrichment claim premised on allegations that transfer was made with actual fraudulent intent is not preempted by section 546(e)).
- Although not at issue in *Merit Management*, sections 546(f) and 546(g) of the Bankruptcy Code provide similar safe harbors for transfers made in connection with repurchase agreements and swap agreements.

# Circuit Split Regarding 546(e) Prior to *Merit Management*—the *Majority* Position

- The defense requires, among other things, that the payment be made “by or to (or for the benefit of)” certain qualified transferees, including a “financial institution.” Because security trades are commonly settled through financial institutions, most appellate courts had found the presence of a financial institution, even if it had no beneficial interest in the underlying transaction, to be sufficient to meet the Code’s requirement that the transfer be “made by or to” a financial institution.
- The majority of Circuit Courts had held that the presence of a financial institution, even if it had no beneficial interest in the underlying transaction, to be sufficient to meet the Code’s requirement that the transfer be “made by or to” a financial institution.
  - *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 338-39 (2d Cir. 2011) (held section 546(e)'s safe harbor was available because "undoing Enron's redemption payments, which involved over a billion dollars and approximately two hundred noteholders," would have "a substantial and similarly negative effect on the financial markets"; a financial intermediary that does not take title to securities during a transaction is entitled to safe harbor protection.)
  - *In re Quebecor World (USA) Inc.*, 719 F.3d 94, 99-100 (2d Cir. 2013) (held that to prevent portions of section 546(e) from becoming superfluous, "a transfer may be either 'for the benefit of' a financial institution or 'to' a financial institution, but need not be both.")
  - *In re Resorts Int'l, Inc.*, 181 F.3d 505, 515 (3d Cir. 1999) (held (held, section 546(e) does not specify that the safe harbor is available only when the financial institution has a "beneficial ownership" in the funds at issue);
  - *In re QSI Holdings, Inc.*, 571 F.3d 545, 550 (6th Cir. 2009) (held payments to selling shareholders in LBO of privately held securities insulated by § 546(e))
  - *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009) payments to selling shareholders in LBO went through financial institution and were insulated by § 546(e))
  - *In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991) (definition of "settlement payment" is "extremely broad"; exchange of stock for consideration in LBO was "settlement payment" under section 546(e))

# Circuit Split Regarding 546(e) Prior to *Merit Management*—the Minority Position

- A divided panel of the Eleventh Circuit held that section 546(e) of the Bankruptcy Code is inapplicable if a financial institution involved in a transaction is a "intermediary or conduit" because a trustee may only avoid a transfer to a "transferee" that is a protected entity listed in section 546(e) and has a beneficial interest in the assets at issue. *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996).

# Background of *Merit Management*

- *Merit Management* involved two companies that wanted to open a "racino," which is a harness horse racing track and a casino. Harness racing is a closely regulated industry in Pennsylvania that requires a license to operate a racetrack.
- In 2003, two companies were in competition for the last harness-racing license in Pennsylvania: Valley View Downs, LP, and Bedford Downs Management Corporation.
  – Both companies were denied a license in 2005 on technical grounds.
- To strengthen its chances at securing the racing license, Valley View decided to buy out the competition. Thus, in August 2007, Valley View, Bedford Downs, and others entered into a settlement agreement. The settlement agreement required Valley View to pay Bedford Downs $55 million in exchange for all of Bedford Downs's stock. Valley View and Bedford Downs also entered into an escrow agreement.
  – The District Court defined the settlement agreement and the escrow agreement as the "Securities Contracts."
- With Bedford Downs out of the way, Valley View was awarded the license. As part of a larger financing transaction, Valley View had its bank escrow the $55 million payment.

# Background of *Merit Management* (cont.)

- In October 2007, Bedford Downs shareholders, including Merit Management Group, LP, deposited their stock certificates into escrow.  At closing, Valley View received the Bedford Downs stock certificates, and, ultimately, the $55 million was released to the shareholders.  Merit received approximately $16.5 million for its shares.
- The closing statement for the transaction reflected Valley View as the "Buyer," the Bedford Downs shareholders as the "Sellers," and $55 million as the "Purchase Price."
- Valley View never received a separate gaming license, and thus, was unable to open the racino.  Thereafter, Valley View and its parent company, Centaur, LLC, filed for Chapter 11 bankruptcy.  The Bankruptcy Court confirmed a reorganization plan and appointed FTI Consulting, Inc., to serve as trustee of the Centaur litigation trust.

# Background of *Merit Management* (cont.)

- FTI filed suit against Merit seeking to avoid the $16.5 million transfer from Valley View to Merit for the sale of Bedford Downs' stock. The complaint alleged that the transfer was constructively fraudulent under section 548(a)(1)(B) of the Code because Valley View was insolvent when it purchased Bedford Downs and "significantly overpaid" for the Bedford Downs stock.
- Merit moved for judgment on the pleadings under Federal Rule of Civil Procedure 12(c), contending that the section 546(e) safe harbor barred FTI from avoiding the Valley View to Merit transfer.
- Merit contended that the transfers were made "by or to" a financial institution (here, Credit Suisse and Citizens Bank) because financial institutions transferred and received funds in connection with the transaction.

# Background of *Merit Management* (cont.)

- The trustee asserted that § 546(e)'s requirement that a transfer be "by or to" a financial institution applies only to a financial institution that is:
  - (i) a debtor-transferor;
  - (ii) a transferee that is not a mere conduit; or
  - (iii) an entity on whose behalf the transfer was made.
- The trustee contended that the financial institutions (Credit Suisse and Citizens) had no beneficial interest in the funds; Valley View was the debtor-transferor and the entity on whose behalf transfer was made, Merit was the transferee, and neither Valley View nor Merit is a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency. Thus, the trustee argued that § 546(e)'s "safe harbor" does not shield the transfers between Valley View and Merit Management.

# Background of *Merit Management* (cont.)

- The District Court granted Merit's motion for judgment on the pleadings. *FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 541 B.R. 850 (N.D. Ill. 2015).
- The Seventh Circuit, however, reversed the District Court's decision. *FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 830 F.3d 690 (7th Cir. 2016).

# The Question Faced by the Supreme Court: Do Intervening Transfers Matter?

- The Supreme Court was "asked to determine how the [Section 546(e)] safe harbor operates in the context of a transfer that was executed via one or more transactions
  - *e.g.*, a transfer from A → D that was executed via B and C as intermediaries, such that the component parts of the transfer include A [Valley View] → B [Credit Suisse Cayman] → C [Citizens Bank (escrow agent)] → D [Merit Management]."
- Here, the trustee sought to avoid the transfer from A (Valley View) to D (Merit Management) and ignore the intervening transfers.
- Did the intervening transfers to financial entities (B and C) covered by 546(e) permit Merit Management to avail itself of the safe harbor?

# The Supreme Court's Decision

- The Court held that the "overarching transfer" that the trustee is seeking to avoid, rather than component transactions, determines whether the safe harbor applies.
- Merit did not argue that FTI had improperly identified the Valley View to Merit transfer as the transfer to be avoided.  Rather Merit focused on whether FTI could ignore the component parts (the Credit Suisse transfer and the Citizens escrow).  The Court considered those two component parts of the transfer irrelevant.
- Accordingly, the Valley View to Merit transfer fell outside the safe harbor.

# The Supreme Court's Decision (cont.)

- As both section 546(e) and the avoidance provisions (Bankruptcy Code sections 544, 545, 547, 548(a)(1)(B), and 548(b)) discuss "transfers," the Court held that the transfer subject to the safe harbor must be the transfer that would be subject to avoidance.
- The Court held that *only* the transfers set forth in section 546(e) were subject to the securities safe harbor. *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 894 (The transfer that the “the trustee may not avoid” is specified to be “a transfer that is” either a “settlement payment” or made “in connection with a securities contract.")
- The safe harbor protects transfers that are "settlement payments" or made "in connection with a securities contract." The Court held that the transfer the trustee seeks to avoid must be a transfer that is either a settlement payment or in connection with a securities contract and not one that merely "involves" or "comprises" such a transaction.
- The Court dismissed the possibility that a trustee could artfully plead a transfer to avoid the safe harbor.

# *Merit Management's* Impact on Fraudulent Transfer Litigation

- It is clear that the Section 546(e) safe harbor has narrowed after *Merit Management* – but by how much?
  - The practical effect on pending and future fraudulent conveyance actions is not yet clear
  - The pending *Tribune* case in the Second Circuit could provide more clarity

# The Pre-*Merit Management* World

- Before *Merit Management*, Section 546(e) was a broad safe-harbor essentially barring all constructive fraudulent transfer claims under the Bankruptcy Code with respect to settlement payments and transfers made in connection with securities contracts

# The Pre-*Merit Management* World (cont.)

- Five Circuit Courts, including the Second Circuit, had held that the further requirement that the transfer be made by, to or for the benefit of certain covered entities, including "financial institutions" was satisfied even if the covered entity acted as an intermediary or "mere conduit."

# The Pre-*Merit Management* World (cont.)

- As a result, before *Merit Management* only intentional fraudulent transfer claims under Section 548(a)(1)(A) of the Bankruptcy Code were not barred in this context
- Some creditors tried to get around the 546(e) safe harbor by bringing state law constructive fraudulent transfer claims directly
  - That is, the creditors avoided bringing claims under the Bankruptcy Code and instead brought substantively identical claims under state law
- These "end run" attempts met with mixed success
  - The one federal appeals court to consider this issue held that the 546(e) safe harbor preempted the state law constructive fraudulent transfer claims.  That case was the *Tribune* case in the Second Circuit

# *Merit Management*

- *Merit Management* arguably upended this body of case law by holding that the relevant transfer for purposes of the 546(e) safe harbor is the "overarching transfer that the trustee seeks to avoid."

# *Merit Management's* Potential Impact Could be Clarified in the *Tribune* Case

- *Tribune* could be a good case study of what the impact of *Merit Management* might – or might not – be in the context of avoidance actions
- *Tribune* is a large LBO claw-back case
  - Actions seek to recover proceeds from the LBO from shareholders who received payment for their shares in connection with the LBO
  - Two strands to the case:
    - State law constructive fraudulent transfer claims brought directly by creditors
    - Intentional fraudulent transfer claims brought under the Bankruptcy Code by a Litigation Trustee

# *Tribune* Cases Pre-*Merit Management*

- Before *Merit Management* was decided, the *Tribune* plaintiffs had lost every substantive round in the case
- The Second Circuit had held that the state law constructive fraudulent transfer claims were preempted by 546(e)
  - The principal question was whether 546(e)—a federal law safe harbor—preempted the creditor's state law claims
  - The parties agreed that 546(e) would bar a constructive fraudulent transfer claim brought directly by the Litigation Trustee under the Bankruptcy Code

# *Tribune* Cases Pre-*Merit Management* (cont.)

- When *Tribune* was briefed and argued in the Second Circuit, the law was clear that 546(e) applied even if the financial institution involved in the transfer was a mere conduit.
  - 546(e) protects transfers "by or to (or for the benefit of)" financial institutions, so the law was that a transfer from Tribune to its shareholders contained a transfer "by or to" a financial intermediary
  - It was undisputed that there was such a financial intermediary in *Tribune*
- The Litigation Trustee action, which included intentional fraudulent transfer claims, brought under the Bankruptcy Code, had been dismissed by the District Court

# *Tribune* Cases Post-*Merit Management*

- After the decision in *Merit Management*, two Supreme Court justices issued a “statement” suggesting that the Second Circuit or District Court recall the mandate in Tribune to consider the impact, if any, of *Merit Management*
  - The Second Circuit has recalled the mandate
- Issues of broad application
  - Does *Merit Management* impact the Second Circuit's preemption decision?
  - What is the significance of the "customer" argument in footnote 2 of the *Merit Management* opinion?

# Preemption of State-Law Claims

- *Merit Management* does not discuss (or even mention) preemption
- The *Tribune* Plaintiffs, however, argue that the underpinnings of Second Circuit's decision were undermined by *Merit Management*
  - Specifically, Plaintiffs contend that *Merit Management* explicitly rejected the approach employed by the Second Circuit in interpreting 546(e)

# The "Customer" Argument

- The "customer" argument is based upon the definition of "financial institution" in the Bankruptcy Code
  - The Bankruptcy Code defines “financial institution” as “a Federal reserve bank, . . . commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such . . . entity is acting as agent or custodian for a customer . . . such customer.”

# The "Customer" Argument (cont.)

- At oral argument in *Merit Management*, Justice Breyer made clear that the definition of “financial institution” included “customers” of such financial institutions and wondered out loud why Merit had not made that argument
  - The Supreme Court ultimately declined to decide this issue because it had not been raised:

    > The parties here do not contend that either the debtor or petitioner in this case qualified as a “financial institution” by virtue of its status as a “customer” under § 101(22)(A). Petitioner Merit Management Group, LP, discussed this definition only in footnotes and did not argue that it somehow dictates the outcome in this case . . . . We therefore do not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor.

    *Merit Management*, 138 S. Ct. at 890 n.2.
- This argument could render *Merit Management* a decision of limited impact

# Issues that *Merit Management* Foreshadows

- *Merit Management* could mean that there will be substantial focus on the definitions of the 546(e) covered entities: who counts as a financial institution or financial participant?
  - For instance, a "financial participant" includes entities that hold "gross mark-to-market positions" of not less than $100 million in certain "agreements or transactions," including "securities contracts"
- In many cases the questions of whether an entity qualifies as a financial institution or financial participant will be (or should be) clear
  - Nevertheless, there is likely to be substantial litigation on these questions

# Implications of *Merit* Outside the Context of Avoidance Actions

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# Some Broader Implications of *Merit*

- The Code contains a number of "safe harbors" for financial contracts in addition to Section 546(e).

- *Merit* is the first Supreme Court case to address any of these safe harbors.

- The Court's interpretative approach in *Merit* may affect how courts interpret these safe harbors going forward.

- The implications of these interpretations may extend outside the context of creditors' rights and into the regulatory space.

# Overview of Broader Safe Harbor Considerations

- Automatic Stay and Anti-*Ipso Facto* Provisions
- Protections for Close-out Netting Rights
- Protections for Other Financial Contracts

# Overview of Other Safe Harbors

# The Automatic Stay

A bankruptcy filing imposes a broad stay of actions against the debtor and its property, including:

- Foreclosure on property of the debtor
- Termination of contracts with the debtor
- Commencement or continuation of legal actions against the debtor or its property
- Setoffs*

* Spelled as set forth in § 553 of the Bankruptcy Code.

# Ipso Facto Clauses Generally

*Ipso Facto* Nullification

A bankruptcy filing prohibits the enforcement of clauses in executory contracts (*i.e.*, contracts where there are material unperformed obligations on both sides of the contract) that, upon the debtor's filing, purport to allow for either (i) the termination or (ii) the modification of the contract based on the debtor's bankruptcy or financial condition:

— (a) the insolvency or financial condition of the debtor at any time before the closing of the case, (b) the commencement of any bankruptcy case, or (c) the appointment or taking possession by a trustee in a bankruptcy case or a custodian prepetition. 11 U.S.C. § 365(e).

These types of clauses are called "*ipso facto* clauses."

# Tension Between the Automatic Stay and Financial Markets

The automatic stay is a necessary breather for the debtor, but . . .

With respect to certain types of financial contracts, absent certain protections, counterparties to such contracts could sustain immediate and significant losses long before a bankruptcy court could address their rights under their contracts.

## What are the Safe Harbors, and what benefits do Qualified Financial Contracts have under the US Bankruptcy Code?

# Congress Addresses the Tension between the Stay and Fast-Moving Financial Markets

Recognizing the potentially damaging ripple effects that would result if a major player in the financial markets filed for bankruptcy, Congress enacts the so-called "safe harbor" provisions, which are designed to protect the financial markets from systemic risks.

Broadly, in addition to the litigation protections discussed earlier, the safe harbor provisions also assure a party that it will be able to promptly terminate its financial contracts and exercise its rights of liquidation, netting and setoff and rights in respect of collateral if its counterparty files for bankruptcy relief.

# Protections for Close-out Netting Rights

Specifically, the Code Protects:

| | |
|---|---|
| **Termination, Liquidation & Acceleration**<br><br>11 U.S.C. § 555 | "The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract . . . because of [the insolvency or financial condition of the debtor] shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ." |
| **Netting**<br><br>11 U.S.C. § 362(b)(6) | "The filing of a petition . . . does not operate as a stay—of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any . . . contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more [securities contracts] . . . ." |
| **Collateral Rights**<br><br>11 U.S.C. § 362(b)(6) | "The filing of a petition . . . does not operate as a stay—of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any [securities contract] . . . ." |

# Protections for Other Financial Transactions

The Code also extends anti-avoidance protections and protections for close-out rights to other kinds of financial contracts:

- **Forward Contracts** (11 U.S.C. §§ 101(25), 362(b)(6), 556)
- **Commodity Contracts** (11 U.S.C. §§ 761(4), 362(b)(6), 556)
- **Repurchase Agreement** (11 U.S.C. §§ 101(47), 362(b)(7), 559)
- **Swap Agreement** (11 U.S.C. §§ 101(53B), 362(b)(17), 560)
- **Master Netting Agreement** (11 U.S.C. §§ 101(38A), 362(b)(27), 561)

# Will *Merit* Add Greater Uncertainty to Counterparties Acting in Reliance on Safe Harbor Provisions? A Discussion of Some Recent Decisions

# *In re FirstEnergy Solutions, Inc.* – Risks of Terminating without Certainty that Safe Harbor Applies

*Memorandum Decision Regarding Debtors' Motion to Enforce the Automatic Stay and for Contempt, Concluding that Meadville's Forging Company's Actions To Terminate Its Power Supply Contract with Debtor FES was Unlawful and Constituted a Violation of the Automatic Stay* (Jan. 15, 2019)

— Non-debtor terminated contract, notwithstanding the automatic stay, pursuant to 11 U.S.C. § 556

- Claimed safe harbor that agreement with FES was a forward contract and non-debtor was a "forward contract merchant"

— Court disagreed and found termination violated stay; will hold further hearing on damages as well as sanctions for violation of automatic stay

## *In re FirstEnergy Solutions, Inc.* – Risks of Terminating without Certainty that Safe Harbor Applies

- Following the filing of the Debtors' bankruptcy petitions, Meadville notified FES that Meadville was considering terminating a supply agreement with FES because electricity could be purchased more cheaply and because Meadville believed the terms of the agreement permitted Meadville to terminate it because of the bankruptcy filing
- FES contested that and subsequently sued Meadvile for stay violation
- Parties stipulated that electricity is a "commodity" and the agreement was a "forward contract," as each of those terms are defined in the Bankruptcy Code.
  - While court acknowledged those as being "at least in part conclusions of law," the court accepted the parties' joint stipulations.

# *In re FirstEnergy Solutions, Inc.* – Risks of Terminating without Certainty that Safe Harbor Applies

— Court found that it was not bound, however, by the plain text of the agreement which provided that both parties were forward contract merchants as that term is used by the Bankruptcy Code.

- ‘[T]he parties cannot directly agree to confer legal status as forward contract merchant on Meadville, and bind this Court to that conclusion, any more than they could have backed into that status by mutually signing an agreement stipulating that Meadville is a Federal Reserve Bank.”

— Court concluded that for Meadville to be a forward contract merchant, its business must consist, in whole or in part, of entering into forward contracts for electricity.

- “More specifically, Meadville must enter into forward contracts for the purchase and sale of electricity to generate a profit. Merely entering into supply contracts as an end user of electricity is insufficient.”

— Court concluded that Meadville was solely an end user, and therefore its termination was not safe harbored

# *In re FirstEnergy Solutions, Inc.* – Risks of Terminating without Certainty that Safe Harbor Applies

Court's decision did not reach the issue of sanctions, including:

— what acts constituted a willful and/or bad faith violation of the stay;

— what legal theory of sanctions would be appropriate; and

— what amount of sanctions would be supported by evidence that may be introduced.

Court to set a schedule for hearing on those issues

Decision continues trend – not necessarily started, but perhaps accelerated by, *Merit* – of reading safe harbors narrowly

# *In re American Home Mortgage Inc.* – Mortgage Servicing Rights not Covered by Safe Harbors

Servicing is one of the key aspects covered in a repurchase agreement relating to mortgage loans.

However, in *In re American Home Mortgage Inc.*, the Delaware bankruptcy court held that, while qualifying repos must be given the benefits of the "safe harbor" provisions, servicing, which, in the case before it, had been retained by the repo seller, was not protected by the safe harbor provisions.

***Result***: Despite the buyer arguing that (i) the servicing was a "related term" of the repurchase agreement, and (ii) as it terminated the repos, it also had the right to terminate the servicing agreement, the bankruptcy court rejected that argument.

# *In re American Home Mortgage Inc.* Revisited

In the intervening years since *American Home*, parties have engaged in various degrees of wordsmithing to more accurately reflect their intention to include servicing and other types of provisions as a “related term” under § 101(47)(a)(i).

However, case authority (particularly published authority) is very limited on what are related terms to qualified financial contracts

Next cycle may see more litigation over what types of ancillary rights can be terminated or modified in the context of acceleration, liquidation or termination of a qualified financial contract

# *In re Samson Resources Corp.* – First Day Hedging Arrangements

Samson Resources filed in Delaware in September 2015; one of the largest independent oil and gas producers in U.S.

Prepetition debt included approximately $1 billion RBL facility

— As is typical in most RBL facilities, borrower was required to mitigate commodity price risk by entering into hedges relating to future production (i.e., not speculative hedges)

At time of filing, because of substantial decline in natural gas prices, commodity hedges were over $100 million "in the money" for the borrower

— A substantial portion of the hedges were with lenders in the RBL facility, and contained requisite language in section 6f of the ISDA Schedule allowing setoff

— Similarly, the security agreement relating to the RBL credit agreement provided the lenders a lien on and security interest in the proceeds of any hedges

# *In re Samson Resources Corp.* – First Day Hedging Arrangements

Prior to the petition date, the borrowers and certain hedge counterparties negotiated heavily over potential termination of the hedges

Undisputed that hedges constituted "swap agreements" and consequently, termination would have been safe harbored under §§ 362(b)(17) and 560

However, dispute arose as to whether setoff against principal owed on the RBL facility was safe-harbored (or instead would require court approval to be consummated)

— Parties disagreed over whether the relevant rights under Section 6f of the ISDA Schedule or the RBL security agreement constituted a "security arrangement or credit enhancement … forming part of or related to" those hedges

# *In re Samson Resources Corp.* – First Day Hedging Arrangements

To preserve dispute for a later date, DIP financing order provided unique provisions relating to hedges

- Parties stipulated that termination events had occurred as a result of bankruptcy filing
- Parties stipulated, and court ordered, that upon certain subsequent and specified "Hedge Termination Events" counterparties could terminate the hedge agreement based on bankruptcy filing
- Debtors and, later, official committee of unsecured creditors agreed to toll any period for a timely termination and agreed that they could not contest the timeliness of such termination
- Monthly hedge payments were placed in segregated account and not subject to use as cash collateral

Ultimately, was a win-win, as the Samson debtors were able to continue to collect monthly hedge settlement payments while commodity prices rebounded; proceeds were ultimately used at exit to pay down RBL lenders' prepetition secured claims

# *Merit*’s Interpretive Approach

# *Merit*'s Interpretive Approach: Textualism and Contextualism

- Consistent with the Courts' recent interpretive trend, the Court focused on **statutory text and context** to determine whether the transfers at issue were within the scope of Section 546(e):

  > *"The* ***language of § 546(e), the specific context in which that language is used, and the broader statutory structure*** *all support the conclusion that the relevant transfer for purposes of the §546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid under one of the substantive avoidance provisions."*

- The Court only briefly addressed Congress's purpose in enacting the safe harbors and only in response to the petitioner's arguments.

- However, the Court never categorically rejected the possibility of looking to purpose.
  - It specifically noted the background for Congress's enactment of the provisions.
  - Justice Gorsuch asked what effect the Court's ruling could have on financial markets.

# The Implications of a Textualist and Contextualist Approach

# How *Merit*'s Interpretive Approach Could Affect the Scope of Protected Rights

- Generally speaking, the protections for close-out rights are very broadly worded:
  - Section 555 (and the analogous provisions for other QFCs) protect the "right to terminate, liquidate or accelerate" a QFC.
  - Section 362(b)(6) (and the analogous provisions for other QFCs) protect "any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any" QFC.

A textualist approach counsels giving ***each of these words an independent meaning***.

A textualist approach counsels reading this provision to protect ***any right*** under a security agreement, guarantee, or other credit enhancement.

# How *Merit*'s Interpretive Approach Could Affect the Scope of Protected Contracts

- Many of the QFC definitions are broadly worded so as to encompass new transactions and products (e.g., cryptocurrency derivatives).
- For example, the definition of "swap agreement" includes:
  - (I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap; (II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement; (III) a currency swap, option, future, or forward agreement; (IV) an equity index or equity swap, option, future, or forward agreement; (V) a debt index or debt swap, option, future, or forward agreement; (VI) a total return, credit spread or credit swap, option, future, or forward agreement; (VII) a commodity index or a commodity swap, option, future, or forward agreement; (VIII) a weather swap, option, future, or forward agreement; (IX) an emissions swap, option, future, or forward agreement; or (X) an inflation swap, option, future, or forward agreement;
- It also includes any similar agreement that becomes the subject of recurrent dealings in the derivatives markets and is a:
  - forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

# How *Merit*'s Interpretive Approach Could Affect the Scope of Protected Contracts

- So as to limit the scope of this definition, some courts, prior to *Merit*, required a connection of a putative "swap agreement" to financial markets:

  *It is undoubtedly true that Congress sought . . . to effect greater protections of financial markets from the disrupting effects of bankruptcy and therefore to* ***require a relationship between a commodity forward agreement and the financial markets***.
  *In re Nat'l Gas Distr., LLC*, 556 F.3d 247 (4th Cir. 2009).

- Some courts also imposed specific limitations on the scope of "swap agreements" and "forward contracts" to ensure the contracts were aimed at achieving a hedging or speculative purpose.

Following *Merit*, it is less clear whether these precedents will continue to hold.

# *Merit* in Action: *Lehman Brothers Special Financing Inc. v. Bank of America National Association* (S.D.N.Y. Mar. 14, 2018)

- The *Lehman* bankruptcy has led to a number of cases concerning the scope of the safe harbors.
- One recent case concerns whether Section 560 of the Code applies to "Priority Provisions" related to swap agreements.

> *Priority Provisions* prescribe the order in which distributions of collateral proceeds are to be made to certain creditors, including the debtor, under certain circumstances.

- In that case, a district court for the Southern District of New York held that Section 560's protection of a contractual right to liquidate a swap agreement encompassed the exercise of rights under the Priority Provisions.
- While "bearing in mind [Section 560's] purpose of protecting the financial markets from uncertainty due to the risk of swap agreements not being honored in bankruptcy," the court's analysis focused heavily on a "literal reading" of the statutory text.
  - The court looked to financial, legal, and general dictionaries to interpret "liquidate".
- Citing *Merit*, the court also looked to the context in which the term "liquidate" was used, *i.e.*, Section 560, which the court held was "concerned with bringing swap agreements to an end and distributing collateral."

# Implications Beyond Bankruptcy

# Similar Safe Harbors Exist in Other Insolvency Statutes

- Other insolvency regimes provide similar safe harbors for close-out netting rights and pre-insolvency transfers:

  - **Federal Deposit Insurance Act** (12 U.S.C. § 1821(e))

  - **Securities Investor Protection Act** (15 U.S.C. §78eee(b)(2)(C))

  - **Orderly Liquidation Authority Title of the Dodd Frank Act** (12 U.S.C. § 5390(c))

  - **Insolvency laws applicable to GSEs, credit unions, and certain insurance companies**

- Many of these regimes refer to the protected agreements as "qualified financial contracts".

# Capital and Margin Requirements

- The Basel capital requirements allow a bank to recognize certain exposures under an agreement on a net basis and to recognize the benefits of collateral, if the bank has a well-founded basis that it can:

  ***"accelerate, terminate, and close-out on a net basis all transactions under the agreement and . . . liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty . . . ."*** 12 C.F.R. §§ 3.2. 3.3.

- Similarly, recently promulgated rules requiring certain counterparties to uncleared swaps to post and collect collateral (aka "margin") allow the margin requirements to be calculated on a net basis if the regulated entity satisfies the well-founded basis test. *See, e.g.*, 17 C.F.R. §§ 23.151, 23.152, 23.153.

A broad interpretation of the safe harbors, especially with regard to the scope of qualified financial contracts, could expand the ability of banks and other institutions to use these provisions.

# QFC Stay and Recordkeeping Rules

- U.S. financial regulators recently promulgated rules requiring certain bank holding companies, banks and their subsidiaries to maintain comprehensive records of "qualified financial contracts" and to amend those contracts to include certain language. *See*, *e.g.*, 12 C.F.R. Pt. 371, 35 C.F.R. Pt. 148, 82 Fed. Reg. 42882.
  - The rules are designed to facilitate the ability of the FDIC to resolve a bank or systemically important financial institution.

- Although "qualified financial contracts" are defined by reference to the Federal Deposit Insurance Act and Orderly Liquidation Authority Title of the Dodd-Frank Act, those statutes employ definitions of securities contract, commodity contract, forward contract, repurchase agreement and swap agreement that are substantially similar to the Code's.

- As a result, it is quite possible the regulators will look to the Code's case law, including *Merit*, to interpret the scope of contracts subject to the rules.

Therefore, a text-based interpretation that is indifferent to the policy behind the QFC definitions may encompass QFCs that should not be within the scope of the rules and/or exclude contracts that should be in-scope.